S. HRG. 100-465

NATURAL GAS PRODUCT VALUATION—NTL–5

HEARING

BEFORE THE

SUBCOMMITTEE ON MINERAL RESOURCES DEVELOPMENT AND PRODUCTION

OF THE

COMMITTEE ON ENERGY AND NATURAL RESOURCES UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

FIRST SESSION

ON THE

PROPOSAL BY THE DEPARTMENT OF THE INTERIOR TO RETROACTIVELY MODIFY NOTICE TO LESSEES–5 (NTL–5), RELATING TO THE DETERMINATION OF THE VALUE OF NATURAL GAS PRODUCTION FROM FEDERAL AND INDIAN ONSHORE LEASES FOR ROYALTY PURPOSES

JULY 10, 1987

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NATURAL GAS PRODUCT VALUATION—NTL–5

FRIDAY, JULY 10, 1987

U.S. SENATE,
SUBCOMMITTEE ON MINERAL RESOURCES
DEVELOPMENT AND PRODUCTION,
COMMITTEE ON ENERGY AND NATURAL RESOURCES,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:05 a.m., in room SD–366, Dirksen Senate Office Building, Hon. John Melcher, presiding.

OPENING STATEMENT OF HON. JOHN MELCHER, A U.S. SENATOR FROM THE STATE OF MONTANA

Senator MELCHER. The subcommittee will come to order.

This morning we are trying to correct or make sure that something is done on what is called NTL–5. Simply that means the Notice to Lessees-5, which are regulations, and they relate to how you determine the value of natural gas production from Federal and Indian onshore leases. And in determining how you arrive at value, then the percentages for royalty for the owners is applied.

NTL–5 was originally issued in 1977 and required a substantial amount of gas to be valued for royalty purposes at the Federal Energy Regulatory Commission ceiling price. I guess at the start it was all right. But as everybody knows, natural gas prices after 1980, the early 1980s—they started to go down. And so, as the market price fell, that didn't mean that the FERC ceiling price came down. It did not. It was set. Unfortunately, since those regulations were issued in 1977, there hasn't been any adjustment.

Now, when the money is collected off of production, I had always assumed that if you were a royalty owner, you just multiplied the percentage that was due you times the price that the production was sold at, and then you knew how much you were going to get in your check. I can't imagine how we got into a box—when I say "we" meaning the government—got into a box where you would figure out the royalty due estates or Indian tribes or the U.S. Treasury and apply a fixed percentage times a price that was not received for the gas.

If this rule kept the price received at the FERC ceiling price when that wasn't the price received by the producer, I do not understand this. Is the law deficient, or for some reason has the Department of Interior simply issued a regulation and then didn't change it?

Who is going to testify for the Department? Do I understand this correctly? Is this Mr. Bettencort?

Mr. BETTENBERG. Bettenberg.

Senator MELCHER. Bettenberg?

Mr. BETTENBERG. Yes.

Senator MELCHER. Do I understand that correctly? I want to know because I want to complete my opening statement. Do I understand it correctly?

Mr. BETTENBERG. I think that you understand it correctly.

Senator MELCHER. All right.

Now, I do not understand then—and I hope we can have a short hearing. I don't understand how you got there. And if it is a deficient law, I have not been informed. We did not have any testimony from the Department.

Mr. BETTENBERG. That's correct. We don't consider the——

Senator MELCHER. I have asked the Secretary of the Interior—that's your boss. You recognize him as you boss, don't you?

Mr. BETTENBERG. Yes.

Senator MELCHER. I asked him at the beginning of this year. You got a problem here; you tell me. If we're going to need legislation, we'll start moving on it. We have had several bills out here. We have got one out here right now that is going to go on the President's desk, and attaching some corrective language to a bill that you back, Hodel backs, the President backs, this administration backs, is not hard work. When you need corrections—I know this Department is in somewhat of disarray now, and I don't know why, but I'm willing to help.

Now, I have not heard. This is July, going on the middle of July, and I have not heard that you wanted a legislative correction here. So, I hope you can handle it by regulation because I want it straightened out.

Mr. BETTENBERG. We don't have a problem with respect to whether the underlying statute is okay. However, I think that it would be helpful to have some sort of legislative correction on this specific problem.

Senator MELCHER. All right, good. It is about time you get the language up here then. And maybe you are going to present it today. I hope so. I could not find any testimony that was going to be presented by the Department of the Interior yesterday. And so, if you have got something to say, I hope you have come here to say it with language, with recommendation.

Senator Wallop.

STATEMENT OF HON. MALCOLM WALLOP, A U.S. SENATOR FROM THE STATE OF WYOMING

Senator WALLOP. Thank you, Mr. Chairman. I appreciate your willingness to provide interested parties in the NTL–5 issue with an opportunity to express their views for the record. I must say, however, as the Chairman is well aware, I do not as a rule support legislatively mandated moratoria because Congress, frankly, does not need an excuse. And that moratoria generally——

Senator MELCHER. I don't want any misunderstanding, Malcolm.

Senator WALLOP [continuing]. Never completely die.

Senator MELCHER. Don't misunderstand me, Malcolm. When I say legislative remedy, I mean putting this to bed, period, getting it

behind us. I'm not talking about a moratorium. I don't understand any system where you apply a royalty percentage—you take the percentage, whether it's 12½ or 16½ percent, and you multiply it times the price that the gas producer did not receive. Now, I just don't understand. And if we need legislation to correct it, I am willing to do it, but I don't want any moratorium.

Senator WALLOP. Mr. Chairman, if I might continue with my opening statement. After an observation, it is I think usual at least to permit people to finish a statement that they begin.

I have expressed my support for the Minerals Management Service to continue to have the ability to resolve both the NTL–5 regulations and the oil and gas valuation regulations by signing a letter, which was authored by Senator Nickles, to the Chairman and ranking member of this committee, as well as the Chairman of the Senate Interior Appropriations Committee.

The letter stated, among other things, that the 12 signers would oppose any legislative attempts to delay all oil and gas royalty valuation guidelines beyond November 1 of this year. I intend to continue to stand by that, but I must say that I am pleased to note that it appears that a majority of producers, the affected states' governors, including Wyoming's Governor Sullivan, and the Minerals Management Service, appear to be moving toward a patch of common ground on the NTL–5.

It would be my hope that this hearing would further that spirit of cooperation during the next several weeks. And I would also note that the Indian tribes still do have problems with NTL–5, and perhaps we can find some common ground there as well.

At this point I strongly believe that the cloud of uncertainty that any continued legislative delay brings to this issue jeopardizes not only any stability that Wyoming's oil and gas producers may begin to see with $20 a barrel oil, but any corresponding improvements in the health of my state's economy. And I would guess that is the truth for any oil producing state.

I would hope that we do not have a long period of legislative delay. This uncertainty needs to be resolved.

Thank you.

Senator MELCHER. Senator Wirth.

STATEMENT OF HON. TIMOTHY E. WIRTH, A U.S. SENATOR FROM THE STATE OF COLORADO

Senator WIRTH. Thank you, Mr. Chairman. I want to thank you for moving so rapidly in holding this hearing.

This issue has been, as we all know, around since 1977, but most visibly in the last 9 months or so. It was brought to my attention by some friends of mine in the State of Colorado. They suggested that the the conference committee on the supplemental appropriations bill was considering report language that would void the regulations issued by the Department of the Interior early this year, and said that that would be a significant mistake.

I called the Independent Petroleum Association of the Mountain States and asked them if this was an issue of significance to them. They said yes, it was the number one concern that they had and that it was something that we ought to examine right away. We

called the Chairman's office and talked to the staff of the committee, and they agreed that we ought to have this hearing today, and that is why we are here.

In answer to the question raised by Senator Wallop, it appears to me that there is no need for us to have to go through some kind of a legislative moratorium. There is no need for us to have to drag this thing on.

We had what I understand to be—and I would like to hear from you gentlemen today—a perfectly reasonable proposal that came out of the Department of the Interior in January, and something happened to that between January and July. What I would like to know is why we can't simply go ahead, working with the governors who have come up with their own spin on to implement your proposed regulations as soon as we can work through the more narrow and specific problems that the Southern Utes and others may have. But we should go ahead and solve this problem.

We all agree there is a problem. There was a proposal for handling it, and one of the issues I think that we face, Mr. Chairman, is why it was not implemented. This is not something that is going to demand an enormous legislative shootout. I don't think it is something that should have been voided by the House and the Senate. We have a perfectly good proposal. And the reason that we are here today comes out of our friends in the Rocky Mountain Region who said we should go ahead and implement the proposed rule. This is a high priority issue. Let's go ahead and do it. We don't need new legislation. Let's just move out smartly. That's why we are here today.

I am glad that you all are here today, and we want to know—I think this is shared by my colleagues—why we can't go ahead—why you all can't proceed. If there is help that you need from Congress to implement this rule, let us know. If we can act as a broker in getting the parties together, the governors and Indian tribes, we will be happy to do that. But we would like to see this thing resolved and resolved quickly. And I don't understand why we can't go ahead and do it. Maybe you can explain that to us today. It may be that just having this hearing and making use of the Chairman's good offices will expedite this and get it resolved.

So, Mr. Chairman, with that I have an opening statement which I would like to have included in full in the record, if I might. And again, I want to thank you for your very quick response to a serious problem.

Senator MELCHER. It will be made part of the record.

[The prepared statement of Senator Wirth follows:]

STATEMENT OF THE HONORABLE

TIMOTHY E. WIRTH

OVERSIGHT HEARING ON NTL-5

July 10, 1987

Mr. Chairman, I want to thank you for scheduling this hearing on NTL-5. The federal government's rules for royalty management and royalty valuation are complex and controversial. A well run royalty management program is essential to ensuring that the American people receive a fair return on the production of fuel minerals from the public lands. An efficient and fair royalty management program is equally essential to Indian tribes and tribal members, who rely on the Minerals Management Service to collect the royalties that are rightfully theirs. At the same time, the Minerals Management Service has a responsibility under the Mineral Leasing Act, the Federal Oil and Gas Royalty Management Act, and other federal statutes to ensure that its rules and regualtions are fair and reasonable.

This Subcommittee could spend days investigating the royalty management program -- from the valuation of production to the collection and distribution of royalties. We probably should do that. But the scope of today's inquiry is narrow: should the

Minerals Management Service retroactively modify Notice to Lessees- 5.

NTL-5 was issued in 1977 and it essentially required the valuation of natural gas at the ceiling prices set for different categories of gas by the Federal Energy Regulatory Commission and its predecessor agency. That system worked fine during times of energy scarcity -- when producers were able to market natural gas for those prices. But in 1982, the tide began to change. Prices began to decline as supplies became more abundant and predicted load demand never materialized. As purchasers began to demand discounts on natural gas sales, the producers went to the Minerals Management Service to clarify the basis for royalty valuation. In response, the Minerals Management Service notified producers that royalties would be calculated on the basis of fair and reasonable "arms-length" contract prices.

I do not know why MMS did not modify NTL-5 at the time that gas prices were declining. They certainly should have. But the question that the Congress now must address is whether the MMS now should modify NTL-5 retroactively. I think they should -- at least for production from federal lands.

I understand that six Governors -- including Governor Romer of my home state of Colorado -- have informed the Committee that they also agree that NTL-5 may not reflect "reasonable value" for natural gas produced since May 1982, and that some relief from the provisions of NTL-5 should be granted retroactively.

There are many details to be ironed out, but the Governors' position statement is a very large step forward, and I commend them for their hard work on this very difficult issue.

I also recognize that the Secretary of the Interior has a special, fiduciary responsiblity to Indian tribes. The Secretary's responsibility clearly is to maximize the proceeds to tribes and tribal members from natural gas production on their lands. I hope that the Director of the Minerals Management Service, and the other witnesses, will give this Subcommittee the benefit of their counsel on how NTL-5 should be applied to Indian lands.

Senator MELCHER. Senator Nickles.

STATEMENT OF HON. DON NICKLES, A U.S. SENATOR FROM THE STATE OF OKLAHOMA

Senator NICKLES. Mr. Chairman, thank you. And I have a statement as well, and I would like for it to be entered into the record.

And I will just echo the comments that have been made already by yourself and Senator Wallop and Senator Wirth. And I want to thank all of you for your assistance in helping me with the challenge that we had in the supplemental. And I will echo Senator Wallop's statement that I will very vigorously oppose any efforts made, if any efforts are made, in the 1988 bill to prolong and indefinitely postpone implementations of NTL–5. As I understand, and I guess that we will hear shortly that MMS is moving forward on it very rapidly and I think a lot of the problems are being resolved with the states.

And I also agree with Senator Wallop that we need to resolve those problems with the tribes as well. I think we can do so. I think it is just totally absurd not to do so. And congressional attempts to postpone it indefinitely and throw it into a litigation episode, as was I guess advanced by House members totally outside the conference, I vigorously opposed and we were successful in keeping it just to a moratorium through the end of this fiscal year. But no additional moratorium, Mr. Chairman, at least as far as I'm concerned as a member on the Interior Appropriations Committee, will go forward.

We need to resolve these issues. I agree with the Chairman. It has been carrying on far too long, and these things should have been solved and wrapped up several years ago—several years ago. And it is absurd to think that we are still wrestling with it in 1987. A lot of that is water under the bridge. And this needs to be resolved. And I will work with MMS and other members of this committee.

It is interesting to note too that most all the members of this committee were supportive of trying to resolve this in working with MMS, and it was the Appropriations Committee primarily from the House that was causing considerable problems that would basically delay this indefinitely and throw it into litigation.

So, I will work with all parties to see if we can't resolve this. But certainly the solution is that royalties should be charged on market price and not on any NGPA or any other price. I am hopeful that that can be resolved and will be resolved in the very near future.

[The prepared statement of Senator Nickles follows:]

STATEMENT OF SENATOR DON NICKLES
HEARING ON DEPARTMENT OF INTERIOR PROPOSAL TO
MODIFY NOTICE TO LEASEES-5

JULY 10, 1987

Mr. Chairman:

I appreciate the Chairman's interest in this issue, and his arranging for this hearing. We will now have an opportunity to place on the record the facts regarding NTL-5 in a manner that I believe will dispense with much of the serious misunderstanding that has surrounded the Department of Interior's attempts to correct a bad regulation.

I am particularly concerned about the incorrect information that characterized much of the basis of the opposition to the retroactive application of the Department's corrective changes to NTL-5. For example, I understand that the Minerals Management Service has dramatically revised downward their initial, back-of-the-envelope, estimate of the actual refunds from states and Indian tribes that would result if the proposed correction to NTL-5 takes effect. I look forward to hearing Mr. Bettenberg today discuss the basis for their most recent estimate.

I also appreciate the Chairman's decision to restrict this hearing to the proposed rulemaking regarding NTL-5, rather than the general product valuation guidelines. It is my understanding that the oil, gas, and coal valuation guidelines are still being redrafted in anticipation of the publication deadline of August 17, that was set forth in the 1987 Supplemental Appropriations bill. In contrast, it appears that there is considerable unanimity among the interested parties concerning the NTL-5 corrections, which also must be published in draft form by August 17.

It is regrettable that the Minerals Management Service did not respond more quickly to formally correct NTL-5 as soon as they became aware that natural gas

prices could indeed fall below the FERC's maximum price ceilings. Following passage of the NGPA, NTL-5's use of the FERC's ceiling price schedules are best defended as an administratively convenient benchmark. However, the price ceiling levels were only coincidentally--not reasonably--close to the "gross proceeds" received by federal lease operators for their natural gas sales. As natural gas prices fell below FERC ceiling prices, which for section 107 gas began as early as 1982, the coincidental relationship was exposed and the real danger of unreasonable royalty assessments emerged.

To its credit, however, MMS did send written communications to individual lease operators as early as January 1983. For example, Phillips Petroleum Company of Bartlesville, Oklahoma, received a letter from the MMS dated August 4, 1983, in which the service stated that they would use "gross proceeds" received on arm's length contracts rather than the FERC ceiling price levels for calculation of natural gas royalties on federal leases. The MMS also stated in the letter that they were "in the process of issuing regulations and product valuation guidance". It is clear that the sloth of the MMS in issuing the corrective regulations was unfortunate.

It is time to put this matter to rest. I am delighted to hear that the Governors of the six most affected states have agreed in principle to accept a retroactive NTL-5 correction. I look forward to hearing from MMS on how they intend to incorporate this agreement into their final NTL-5 regulations. With respect to the interests of the Indian tribes in NTL-5, I urge the MMS to use their future royalties to indemnify the Indian tribes from any possible refunds that may be required as a result of correcting NTL-5 back through 1982.

Finally, I will take this opportunity to make it absolutely clear that I will vigorously resist any legislative attempts to delay the effective date of final NTL-5 reform beyond November 1, 1987, which is the compromise postponement included in the Fiscal Year 1987 Supplemental Appropriations.

Senator MELCHER. Thank you.

Senator Bingaman.

Senator BINGAMAN. Mr. Chairman, I just have a short statement I'll put in the record. And I look forward to the testimony. I think it is an important issue and one that I'm glad to see us making some progress.

[The prepared statement of Senator Bingaman and Interstate Oil Compact Commission letter follow:]

Statement of Senator Jeff Bingaman
Hearing of the Committee on Energy and Natural Resources
Oil and Gas Royalties
July 10, 1987

I thank the Chairman for scheduling today's hearing on a subject very important to my constituents in New Mexico. The Minerals Management Service (MMS) announced in January its intention to make retroactive proposed reductions in its Notice-to-Lessees No. 5 (NTL-5), which since 1977 has set a value on natural gas for the purpose of calculating royalty payments on Indian and Federal lands. I support the action taken by the agency.

Under NTL-5, producers were directed to value gas at either the contract price or a federally regulated ceiling price set under the 1978 Natural Gas Policy Act (NGPA). A glut in the supply of natural gas beginning in 1982 caused some gas prices to fall. Eventually, the market price for most gas fell below the regulated ceiling price. As a result, NTL-5 required royalties to be paid on a value (the ceiling price) that exceeded what the lessee was able to receive. This placed an unnecessary and unfair financial burden on producers in my state and throughout the nation.

MMS would propose to set the value for royalty purposes at an "estimated reasonable value."

I support the approach recommended by Western Governors who support calculating the reasonable value based on an arms-length contract in situations where a legitimate market-out clause or other events forced the lessee to take less than the FERC ceiling price.

I am pleased the MMS has recognized the inequity of basing royalty payments on NGPA ceiling prices when such prices were not attainable in the marketplace. Fairness and equity to all operators and royalty owners can be achieved through this change.

I look forward to the testimony of today's witnesses.

INTERSTATE OIL COMPACT COMMISSION

HEADQUARTERS OFFICE: 900 N. E. 23RD STREET • P. O. BOX 53127 • OKLAHOMA CITY, OKLAHOMA 73152
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GEORGE A. SINNER
Chairman
Governor of North Dakota

W. TIMOTHY DOWD
Executive Director

July 8, 1987

Senator John Melcher
Chairman, Subcommittee on Mineral
Resources Development and Production
U.S. Senate
Washington, DC 20510-6150

Dear Senator Melcher:

On July 1 you wrote inviting the Interstate Oil Compact Commission (IOCC) to present testimony to your subcommittee on the issue of modifying the Notice to Lessees-5 (NTL-5). I appreciate very much the invitation, as do the other governors who are interested in this measure, but the short notice and prior commitments have made it impossible for any of us to attend.

The NTL-5 has been a troubling issue to the states as well as to the federal government for sometime. At the Midyear Meeting of the Interstate Oil Compact Commission held in Coeur d'Alene, Idaho, late last month, it was decided that the issue had gone on long enough and that it should be brought to a closure. Accordingly, I invited the governors of the six states that appear to be most involved to meet in Salt Lake City on Sunday, July 5, 1987, to see if the states could achieve a consensus. Five of the six governors were present and Governor Carruthers of New Mexico sent a representative with the authority to speak for him. At the conclusion of the meeting a statement was unanimously adopted which sets out our position on NTL-5. Rather than elaborate on, or attempt to explain it, I enclose as the substantive part of this message a copy of the paper entiled "NTL-5 Position." I ask that this letter and that document be made a part of the record at this hearing.

I commend the subcommittee for its concern and interest in this important issue and urge that you join with the governors in seeking to resolve this matter as set out in the enclosed document.

Sincerely,

George A. Sinner

George A. Sinner
Governor of North Dakota
Chairman of the IOCC

GAS/ph
Enclosures

STATE OF WYOMING
OFFICE OF THE GOVERNOR
CHEYENNE 82002

MIKE SULLIVAN
GOVERNOR

NTL-5 POSITION

July, 1987

BACKGROUND:

1. Notice to Lessees and Operators of Federal and Indian Onshore Oil and Gas Leases No. 5 (NTL-5) was issued on June 1, 1977, and generally required that gas be valued at the regulated price approved by the Federal Power Commission. This was subsequently interpreted to mean the Natural Gas Policy Act (NGPA) ceiling price. These ceiling prices were generally comparable to contract prices at that time.

2. Beginning in 1982, gas prices started to decline and continued on their downward slide through 1986 (while NGPA ceiling prices which are inflation adjusted, continued to increase). Through market out clauses or contract renegotiations with pipeline companies, most Federal and Indian lessees received less than NGPA ceiling prices.

3. In 1984 or earlier, the Department of Interior communicated with many lessees indicating their intent to not enforce NTL-5, and to enforce 30 CFR 206.103 for valuation purposes. In general, standard industry practices resulted in royalty payments being made on the basis of gross proceeds received by lessees rather than ceiling prices under NTL-5.

4. Significant questions have surfaced regarding the legality and equity of applying NTL-5 across-the-board to all lessees during the period from May, 1982, when the first market-outs occurred, through August, 1, 1987, when the Department modified NTL-5 prospectively to allow valuation based upon 30 CFR 206.

POSITION:

1. From May, 1982 through August 1, 1986, NTL-5 may not reflect "reasonable value for the product" for royalty purposes as required by law. Relief from the restrictive provisions of NTL-5 should be granted by the Department only on a case-by-case basis through determining reasonable value based upon arms-length contracts, and, at the earliest, following legitimate market-outs or other events which forced a lessee to take a price less than the ceiling price. This appears to require a modification to NTL-5, made applicable retroactively.

2. In determining a reasonable value on a case-by-case basis, protections should be in place to avoid determining value based on verbal agreements, retroactive contracts, non-arms-length contracts, or other considerations apart from legitimate market conditions which may have influenced the lessee's decision to accept less than fair value for the gas. The lessee should have the burden of documenting events or conditions which warrant a departure from NTL-5 in determining value. Gross proceeds should remain the minimum value for royalty purposes. Representatives of the Department of Interior, States and Congress should work together cooperatively to arrive at language which addresses the inequities underlying the NTL-5 issue.

3. States should not bear the financial burden for misguidance or untimely decisions by the Department. Any refunds due companies should be credited against the Federal share of future royalties.

4. The Department should immediately notify lessees to retain all records during this period for audit purposes.

5. The Department and State Auditors should aggressively pursue audits of companies to assure that all royalties due State and Federal governments have been paid.

Colorado	North Dakota
Montana	Utah
New Mexico	Wyoming

STATE OF WYOMING
OFFICE OF THE GOVERNOR
CHEYENNE 82002

MIKE SULLIVAN
GOVERNOR

NTL-5 POSITION

July 6, 1987

BACKGROUND:

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POSITION:

1. From May, 1982 through August 1, 1986, NTL-5 may not reflect "reasonable value for the product" for royalty purposes as required by law. Relief from the restrictive provisions of NTL-5 should be granted by the Department only on a case-by-case basis through determining reasonable value based upon arms-length contracts, and, at the earliest, following legitimate market-outs or other events which forced a lessee to take a price less than the ceiling price. This appears to require a modification to NTL-5, made applicable retroactively.

2. In determining a reasonable value on a case-by-case basis, protections should be in place to avoid determining value based on verbal agreements, retroactive contracts, non-arms-length contracts, or other considerations apart from legitimate market conditions which may have influenced the lessee's decision to accept less than fair value for the gas. The lessee should have the burden of documenting events or conditions which warrant a departure from NTL-5 in determining value. Gross proceeds should remain the minimum value for royalty purposes. Representatives of the Department of Interior, States and Congress should work together cooperatively to arrive at language which addresses the inequities underlying the NTL-5 issue.

3. States should not bear the financial burden for misguidance or untimely decisions by the Department. Any refunds due companies should be credited against the Federal share of future royalties.

4. The Department should immediately notify lessees to retain all records during this period for audit purposes.

5. The Department and State Auditors should aggressively pursue audits of companies to assure that all royalties due State and Federal governments have been paid.

Colorado

North Dakota

Montana

Utah

New Mexico

Wyoming

Senator MELCHER. Senator Hecht.

Senator HECHT. Thank you, Mr. Chairman. No statement.

Senator MELCHER. Thank you.

All right, Mr. Bettenberg, give us your summary please of your statement. Mr. Bettenberg is the Director of the Minerals Management Service for the Department of the Interior.

STATEMENT OF WILLIAM D. BETTENBERG, DIRECTOR, MINERALS MANAGEMENT SERVICE, DEPARTMENT OF THE INTERIOR, ACCOMPANIED BY KEN MOYERS, CHIEF AUDITOR, MINERALS MANAGEMENT SERVICE; AND DON SANT, ASSISTANT DIRECTOR OF PROGRAM REVIEW, MINERALS MANAGEMENT SERVICE

Mr. BETTENBERG. Mr. Chairman, members, if I could introduce my associates. On my right-hand side I have Ken Moyers, who is our Chief Auditor in Lakewood, Colorado; and on my left, Don Sant, who is our Assistant Director for Program Review and an expert on valuation issues and appeals. I may need their help if you have some technical questions.

I appreciate the fact that you are holding the hearing. I certainly would want to associate the Department and myself with the remarks made by all of you. This is an issue that we want to resolve. We thought that we were on the way to resolving it, and we got waylaid essentially by Congress in mid course here. At this point I have been legally prohibited from issuing a final rule for NTL–5 until—or that is, a rule that could take effect before—November 1 because of a rider on the appropriation measure. That rider was sponsored by Congressman Yates.

The Senate put similar language in its version of the appropriations measure, and in conference ended up with the current impasse that we have at the present time.

Let me give you just a brief background on NTL–5 so that everyone will have at least a common understanding of what NTL–5 is, why there was a fair amount of confusion with it, and then what we have tried to do to correct the situation.

Notice to Lessees No. 5 was one in a series of notices to lessees that was issued by the Conservation Division of the Geological Survey during the 1970s. This particular one provided in a number of different sections certain standards that would be applied for valuation of natural gas on shore. It doesn't apply to OCS leases.

It basically said that initially Federal Power Commission (FPC) ceilings, which later became National Gas Policy Act (NGPA) ceilings under Federal Energy Regulatory Commission (FERC,) would become a floor for purposes of royalty valuation. The chart on my right that shows a variety of different NGPA categories, like section 107 gas, 108 gas, 102 gas. The lines on the chart attached to my testimony are essentially those NGPA ceilings as they applied in the 1982 through 1987 period.

Effectively, NTL–5 said that it would establish as a floor what NGPA established as a ceiling. That seems to have worked from the period of 1977 through 1981 because actual prices were one and the same with the ceiling in virtually all instances.

However, in 1982 with a bubble in the amount of supply of natural gas, actual natural gas prices began to fall. That is depicted on

that chart by the declining black line. You can get the flavor of what was actually happening to market prices there. This was not seen by the royalty management people in the Minerals Management Service in 1982, 1983, and into 1984 as that great a problem. The reason is that there is a separate set of regulations that covers oil and gas valuation. It is codified in the Code of Federal Regulations. The prevailing view in the Minerals Management Service apparently was that NTL–5 was an interpretive rule, and if it resulted in an unreasonable outcome, then clearly it should not be applied. In fact, there are some decisions regarding other NTLs where aspects of those were overturned as interpretive rules because they were at variance with the underlying Code of Federal Regulations.

NTL–5 had never been codified. It was promulgated by somebody who normally was not thought of as having the authority to issue rules of this type. As individual companies came in and asked about specific valuation questions on market-out arrangements, they were told on an individual basis that their market-out arrangements would be proper.

In 1985 in an unrelated case involving intrastate gas in Alaska, our Solicitor ruled that NTL–5, because of the way it was promulgated, was in fact a legislative rule and had to be followed. The Solicitor's ruling said that unless it is clearly unreasonable and repugnant to the statute, it had to be enforced.

Our auditors during that period, as they began to do audits of some of these leases, in fact, were beginning to enforce it. In early 1985, we began to have some appeals showing up to demand letters that had been issued on it. We then started the process of developing a new rulemaking.

We issued a proposed rule in January 1986 and asked a number of questions about the retroactivity issue. At that time we were opposed on the retroactivity issue by all of the States and all of the tribes. Industry favored that proposal. We didn't clearly understand the economic impact of retroactivity. We were, in fact still are, reluctant to go back and retroactively change rules.

As a result, in July of last year, we moved forward with a prospective-only rule. There does not seem to be any opposition to the underlying principles in that prospective rule.

As we gained further experience with the extent of the unreasonableness of applying the FERC ceiling in the 1982–1985 period, we concluded that we, in fact, had made a serious mistake, and that we needed to go back and correct the rule. In January 1987 we proposed a retroactive rulemaking.

If we move to the second chart, what we discover is that the effective royalty rate, the rate of royalties being required under NTL–5 for intrastate gas regulated under FERC ceilings as a percent of actual amounts received, was climbing steadily and for tight sand gas, section 107 gas for instance, by 1986 had reached some 30 percent. That was rather stunning considering that the leases were calling for 12½ percent of value.

We proposed that rule in January of this year and opened it up for an extensive comment period. Again, we got general opposition from the States and the tribes. Industry was favorably disposed towards it. We concluded that a part of the problem, in terms of the opposition that we had, was that a number of people appear to

have thought that we were going to go to some sort of market-out price independent of whether companies were actually receiving that price. We had established a series of dates in our proposed rule so that each category of gas had a different market out date; For instance, for section 107 gas the date was May 1982.

There was also a view on the part of some apparently, a misinterpretation, that we might apply that market[ed]-out price for one specific lease to all section 107 leases. That is not what the rule says. That had never been our intention. Our requirements are to go through these leases on a case-by-case basis.

When that became clear, the western governors concluded that, in fact, case-by-case analysis was the proper approach to use. They have concluded that they support making the change, doing it on a case-by-case basis.

The final sticking point is that we had collected some amount of money under the provisions of NTL–5. Our estimate at this point, is that approximately $500,000 was actually collected. That portion of it relating to Indians would have been paid out to the tribe or allottees. That amount would be approximately $85,000. Half of the remainder would have been paid to the States in accordance with the Mineral Leasing Act.

The States have asked as a settlement of this issue that we not call for recoupment. We are amenable to that. The governors met last Sunday and agreed to that position. We agreed with them that we would have a technical meeting next week in Denver, Colorado. That is arranged now. We will be meeting with representatives of all six States to formulate some language that might be introduced in Congress and to stipulate as to the audit procedures that we will be using on NTL–5 audits.

We hope that that will resolve the issue. It is one that needs to be resolved.

We have called for a meeting of those tribes that are most heavily impacted by the decision for the following Thursday. Those letters and calls are going out now. We would like to see if we can resolve this issue with the Indians on the same basis that we have resolved it with the States.

I think that our indications are that the Senate Appropriations Committee would look favorably upon this, although that is certainly no guarantee. I would predict that that kind of a proposal still could have problems in the House. And so, we will have to see what comes of that.

[The prepared statement of Mr. Bettenberg follows:]

OPENING STATEMENT OF WILLIAM D. BETTENBERG
DIRECTOR, MINERALS MANAGEMENT SERVICE

Before The
Senate Energy and Natural Resources Committee
Subcommittee on Mineral Resources Development and Production
July 10, 1987

I want to thank the Chairman and Members of the Subcommittee for the opportunity to appear today to discuss the Minerals Management Service (MMS) proposal to make changes to Notice to Lessees No. 5 (NTL-5), which governs the value for royalty purposes of natural gas produced from onshore Federal and Indian lands.

The MMS has, as one of its major responsibilities, the collection and disbursement of oil, gas, and other receipts from mineral leases on Federal, Indian and Outer Continental Shelf (OCS) lands. The majority of these mineral revenues are in the form of royalties paid to the MMS for oil and gas production. The determination of the amount of royalty payable under an oil and gas lease is a function of the value of the production and the royalty rate. NTL-5 prescribes the procedures to be used to determine the value, for royalty purposes, of natural gas production from onshore Federal and Indian oil and gas leases. NTL-5 does not apply to OCS leases.

In any discussion of NTL-5, it is important to understand the context and circumstances in which it was issued. NTL-5 was promulgated in 1977 by the Acting Chief of the Conservation Division of the U.S. Geological Survey (U.S.G.S.) after issuance of a proposed NTL and opportunity for public comment. NTL-5 was intended to provide, in the form of an interpretive rule,

contemporary treatment of the underlying regulation at 30 CFR 221.47 (now 30 CFR 206.103), which had last been changed in 1942. That regulation provided that "The value of production for the purpose of computing royalty shall be the estimated reasonable value of the product as determined by the Supervisor . . . ".

NTL-5 was one of a series of Notices issued to lessees between 1974 and 1980 on subjects which, for the most part, directly or indirectly related to royalty payments. The Notices were issued partly in response to reports of the General Accounting Office in 1972 and the Interior Department's Office of Audit and Investigation (now the Inspector General) in 1975 which were critical of the royalty accounting and collection process, including the issue of the lack of clear guidance regarding the proper valuation of production for royalty calculation purposes.

When NTL-5 was adopted in 1977, gas was in short supply. Purchasers were not only willing to pay the Federal Power Commission (FPC) ceiling prices for interstate gas, but were willing to pay in excess of these rates. In formulating the framework for NTL-5, the U.S.G.S. took advantage of the then existing regulatory pricing mechanism to establish estimated reasonable value for royalty purposes rather than creating another mechanism solely for royalty purposes.

NTL-5, as finally adopted, was crafted to address two very different natural gas

markets and two different timeframes. The timeframes were the periods before and after June 1, 1977, the effective date of NTL-5. The marketplaces were the interstate market which was price regulated by the FPC and the intrastate market which was not, in most instances, price regulated. For the interstate market NTL-5 required that, for sales from wells commenced prior to June 1, 1977, and subject to arm's-length contracts, value for royalty purposes be established as the higher of the price received by the lessee under the contract or a minimum value of 18 cents per thousand cubic feet (Mcf). For interstate wells commenced after June 1, 1977, and subject to arm's-length contracts, the value for royalty purposes was to be established as the higher of the price received by the lessee under the applicable contract, or the highest applicable ceiling rate then established by FPC for the same vintage of gas. Also, interstate gas sold under non-arm's length contracts and certain renegotiated arm's-length contracts was to be valued using the post-June 1, 1977, criteria. For the intrastate market, NTL-5 generally required royalty value to be established as the higher of the price received by the lessee under the applicable contract, or the highest price paid or offered for a majority of like-quality gas produced in the field or area.

Since NTL-5 was adopted, the gas shortage has passed and dramatic changes have occurred in the natural gas industry. Most significantly for price regulation of natural gas, the Natural Gas Policy Act of 1978 (NGPA) brought intrastate gas under a federal framework and established, for virtually all domestic gas production, an incentive pricing mechanism which was dramatically different from

the traditional cost-based methodology used by the FPC to establish just and reasonable ceiling rates under the Natural Gas Act of 1938. In place of the FPC historical cost-based methodology which held the price of natural gas at levels below theoretical free market values at the wellhead, the NGPA substituted an incentive pricing scheme that established eight basic categories, with additional subcategories, of natural gas production and a methodology for calculating the appropriate ceiling, or maximum lawful price. The ceiling prices were established in terms of a dollar amount per million Btu's, or in terms of previously existing prices and were increased monthly according to a statutory formula. Statutory provisions also provided for phased price decontrol for most categories of newly discovered gas. Particularly noteworthy was the fact that NGPA provided the Federal Energy Regulatory Commission (FERC), previously the FPC, the authority to increase the maximum lawful ceiling prices for certain categories of gas, but no authority to require a rate lower than the ceiling. Thus the price of natural gas was allowed under NGPA to fluctuate, by contract terms, at any level up to, but not exceeding the applicable maximum lawful price, adjusted for certain reimbursements.

With the passage of the NGPA, NTL-5 became outdated in its framework built to address the intra- and interstate markets. One obvious effect was on NTL-5's provisions related to the previously unregulated intrastate sale of gas. Generally, NGPA used pricing provisions of existing intrastate sales contracts to define maximum lawful price. Consequently, many maximum lawful prices were created. Furthermore, with certain exceptions, all NGPA categories of gas could,

also be sold in intrastate commerce at their respective maximum lawful prices. The introduction of NGPA price regulation to the intrastate sale of gas effectively rendered the majority price requirements of NTL-5 difficult to use in determining estimated reasonable value for royalty purposes.

Despite the NGPA's comprehensive and dramatic change to the method of price regulation in the United States, NTL-5 generally continued to be effective in determining reasonable value for royalty purposes for most gas production from Federal and Indian leases. This can generally be attributed to a strong energy market and the fact that natural gas was, for the most part, selling at maximum lawful prices.

However, beginning in 1982, natural gas prices began to erode, primarily due to declining prices for alternative fuels and increased gas supplies. Competition for fuel supply contracts necessitated reduction of wellhead purchase prices by purchasers to levels below NGPA maximum lawful levels, generally through exercise of contract provisions which allowed the purchaser to reduce the price it would pay as a result of demonstrated changes in market conditions (that is, "market-out" provisions) (Exhibit I). Also, increasing volumes of production began to be sold by producers through special marketing programs and the spot market at prices substantially below the NGPA maximum lawful prices. Furthermore, the FERC, by Order 436, opened interstate pipelines for contract carriage of natural gas to end users. Not only did the economics in the gas industry change dramatically, but the traditional approaches to sale and

delivery of production also changed.

With the fall in commodity value of both oil and gas, natural gas production qualifying for NGPA categories with the highest maximum lawful price was the first to be affected by market-outs. Specifically, NGPA Category 107 (tight formation) production began to be affected by purchaser contract market-outs in mid-1982. Similarly, NGPA Category 108 (stripper well) production was affected about March 1983; NGPA Categories 102 (post-NGPA) and 105 (existing intrastate contract) production in about July 1983; NGPA Category 103 (new onshore) production in about January 1985; and NGPA Categories 104 (old gas), 106 (certain intrastate), and 109 (other) production in about March 1985.

The effect of this precipitous fall in natural gas market prices from NGPA maximum lawful levels could not be accommodated within the requirements of NTL-5. In fact, even as the market prices were falling, the NGPA maximum lawful prices which NTL-5 required to be used in establishing royalty value continued to follow the predetermined statutory increases (Exhibit II). The result of continuing to apply NTL-5 in these circumstances would have been to increase the royalty portion of the proceeds actually received by a producer from a sale significantly above the statutory royalty rate (Exhibit III).

The inability of NTL-5 to accommodate the falling market price of natural gas in 1982 was not considered by MMS to be a royalty valuation problem at the time inasmuch as the regulation (30 CFR 206.103) underlying NTL-5 provided greater

flexibility to determine reasonable values for royalty purposes (Exhibit IV). At the time, MMS operating personnel considered NTL-5 as an interpretive rule and not binding on the agency in inappropriate circumstances.

In response to specific requests for guidance on valuation of natural gas subject to market out actions, the MMS advised payors on a case-by-case basis that it would accept market-out arm's-length contract prices for royalty valuation purposes though such prices were less than the maximum lawful prices allowed by NGPA (Exhibit V). The first MMS correspondence providing this advice was dated January 18, 1983, and related to NGPA Category 107 gas. Similar advice continued to be provided on a case-by-case basis until early 1985. This advice was consistent with valuation requirements of 30 CFR 206.103 for onshore leases and 30 CFR 206.150 for OCS leases which specifically provided for consideration of "price received by the lessee" in determining the value of production for computing royalty.

At about the same time the market price for natural gas began to fall, the MMS had begun drafting gas valuation guidelines for proposed rulemaking. These regulations would replace existing product value regulations in 30 CFR for onshore and OCS leases as well as all royalty-related NTLs including NTL-5. Draft gas valuation guidelines were released for public comment in May 1983 with hearings being held between June and September 1983. After extensive review and consideration of public comments, MMS proceeded in May 1985 with a rewrite of the gas valuation regulations ultimately made available for public comment in

February 1986 and published as proposed rulemaking in February 1987.

In a May 16, 1985, memorandum, the Office of the Solicitor provided legal guidance to the MMS regarding lease terms and regulations governing valuation of intrastate gas production from federal leases in Alaska (Exhibit VI). One of the Solicitor's conclusions was that NTL-5 should be considered a legislative-type rule binding on the agency, not an interpretive rule.

Anticipating this legal guidance related to NTL-5, the MMS had, in April 1985, suspended action on (1) all requests for valuation of contracts with market-out clauses or special marketing programs, and (2) all payment demand letters for valuation issues involving contracts with market-out clauses or special marketing programs as applicable to production on and after March 1, 1984. The purpose of the suspension was to provide the time necessary to amend NTL-5, through the rulemaking process, to permit the MMS, when warranted, to use the provisions of the underlying regulations to establish reasonable royalty values in the changing gas market. A Notice of Proposed Modification to NTL-5 was published in the Federal Register on January 3, 1986. On July 25, 1986, the Notice of Modification to NTL-5 was published in the Federal Register, to be effective prospectively from August 1, 1986. The principal effect of the modification was to permit most gas production from onshore Federal and Indian lands to be prospectively determined in accordance with the valuation regulations in 30 CFR Part 206. The existing provisions of NTL-5 were retained for sales from wells which were producing prior to June 1, 1977, and which were

subject to an arm's-length contract entered into prior to that date.

After the July 25 rulemaking, the MMS continued to analyze the retroactivity issue for which comments were sought in the January 1986 proposed rulemaking. Also, the MMS received many complaints from royalty payors that application of NTL-5 to gas production during the period from 1982 to 1986 lead to results that were unreasonable and contrary to the purposes of the leasing statutes applicable to onshore Federal and Indian lands. Commenters cited cases whereby application of NTL-5 provisions to certain interstate gas production prior to August 1, 1986, resulted in royalty amounts being based on values up to five times the price the lessees actually realized from sales under arm's-length contracts. In the extreme cases cited, the royalty burden specified under NTL-5 would consume nearly all of the proceeds realized from the arm's-length sale. Although the MMS recognized that such disparities between royalty values determined by NTL-5 and the price the lessee could market its gas did not occur in all situations, it was sufficiently prevalent to reconsider whether the recently adopted changes to NTL-5 should be made effective on an earlier date.

In its further evaluation of the retroactivity issue the MMS obtained legal guidance from the Office of the Solicitor (Exhibit VII). The guidance received gave support to the agency's further consideration of retroactive application based on the premise that strict application of the original NTL-5 provisions to establish royalty value resulted, during certain historic periods, in the establishment of royalty values which were so high as to be unreasonable and not

in furtherance of legitimate statutory purposes.

In the January 15, 1987, Federal Register, the MMS proposed to change the effective date of the NTL-5 modifications published in the Federal Register on July 25, 1986. The MMS Notice requested comments on the proposed effective date for the modifications and issues related to consideration of other criteria, such as application to Indian leases and methods and effects of recoupments on Indian leases.

Specifically regarding the retroactivity issue, the MMS proposed to change the effective date of the NTL-5 modifications to a series of different dates for the various categories of gas regulated under the Natural Gas Policy Act (NGPA) by the Federal Energy Regulatory Commission (FERC). The modification to NTL-5 for establishing royalty values would not be effective until the date that a specific category of gas began to be subject to so-called "market-out" clauses whereby the purchaser of the gas was able, because of market conditions to force the price of gas below the FERC ceiling price. For example, for NGPA Category 107 gas, the effective date of modification of NTL-5 would be May 1, 1982, and after that date, each NGPA Category 107 case would be reviewed on a case-by-case basis. However, the original terms of NTL-5 would continue to apply to the other categories of gas until the respective dates as proposed.

Those proposed effective dates were as follows:

NGPA Category	Effective Date of Modification
107	May 1, 1982
108	March 1, 1983
102, 105	July 1, 1983
103	January 1, 1985
104, 106, 109	March 1, 1985

As noted earlier, after the effective date of modification, gas would be valued in accordance with the provisions of 30 CFR part 206. Thereafter, MMS could, but would not be required to, accept the contract price as value for royalty purposes based on a case-by-case review. For example, if in July 1982, two lessees were marketed-out to a price 50 cents below the FERC ceiling price (which is similar to the market-outs of other sellers in the field or area) and a third lessee markets out to a price two dollars below the FERC ceiling, MMS would likely accept the contract price as value for the first two lessees but not for the third. MMS also would apply close scrutiny to non-arm's-length contracts to determine whether the lower prices actually were the result of market forces.

The modifications of NTL-5, if applied to the 1982-1986 period, would give MMS the necessary flexibility under its regulations to establish reasonable royalty values consistent with the underlying statute and regulations. In many instances, these values would continue to be the FERC ceiling prices. However, in situations where the FERC ceiling price no longer reflects a reasonable value, MMS could establish a different value consistent with the regulations in 30 CFR 206.103.

In its evaluation of the potential monetary impact of the proposed modification of NTL-5, the MMS estimates that a maximum of approximately $134.5 million is possibly at issue, with about $125.8 million of that amount applying to Federal leases and about $8.8 million to Indian leases. These amounts represent the estimated royalty differential calculated on the basis of NGPA maximum lawful prices, reached by strict adherence to current NTL-5 requirements, and natural gas prices, usually representing sales proceeds, upon which royalties were actually reported and paid. In practice, the amount actually at issue could be less because our valuation standards can result in royalties being based on amounts in excess of sales proceeds. It is important to consider that to date, the amount of royalty that has actually been paid as a result of audits and is now under appeal, on the basis of the above value differential, is estimated to be approximately $500 thousand (Exhibit VIII). Some additional royalties have been collected as a result of audits that were not appealed. MMS anticipates that if the proposed modification of NTL-5 were to occur, most, if not all, refunds due royalty payors would be accomplished by offsets against future royalty liability. In this regard, special procedures are being contemplated by MMS for Indian leases, and possibly Federal leases, to reduce any potential financial burden.

The MMS is currently pursuing discussions with Governors of six affected States to address the issue of modification of NTL-5, and approaches to resolution of

the issue. The Governors of New Mexico, Colorado, North Dakota, Wyoming, Montana, and Utah have approved a proposed alternative solution to the problem. The basic thrust of the Governors' position is that the reasonable royalty value of onshore natural gas production during the 1982-1986 period would be determined on a case-by-case basis following the time when legitimate market-outs or other events forced a lessee to accept a price less than the NGPA maximum lawful ceiling price. A meeting has been scheduled next week with representatives of these Governors to address the details of this proposal, and, hopefully, bring this issue to closure. A similar meeting is being arranged with representatives of affected Indian lessors.

Mr. Chairman, this completes my prepared statement. I would be pleased to answer any questions you or the Subcommittee members may have.

Exhibit I

El Paso Natural Gas Company

P O BOX 1492
EL PASO, TEXAS 79978
PHONE 915-541-2600

April 3, 1984

Gentlemen:

In accordance with the "Price" article of those gas purchase agreements between you and El Paso Natural Gas Company ("El Paso") which contain such a right, El Paso hereby notifies you that it has determined that its gas supply and market demand environment indicates a downward change in the value to El Paso of all gas priced under NGPA §§ 102, 107 and 108, as applicable, to be purchased from you under such agreements. Therefore, El Paso notifies you of its decision to exercise its contractual right to change the prices otherwise payable for such gas under such contracts (unless a floor price in excess of $4.00 per MMBtu is currently applicable) to an Alternate Price, inclusive of any production-related cost or other add-ons, equal to $3.00 per MMBtu, plus taxes, which price El Paso deems to be indicative of the current value to it of such gas, giving due consideration to all factors affecting such value. Unless you elect to adopt the alternative course described below, which would permit you to collect a price of $3.50 per MMBtu, plus taxes, such Alternate Price of $3.00 per MMBtu, plus taxes, shall become effective on May 1, 1984, and shall remain in effect until further notice from El Paso.

For the reasons that follow, the action described above is necessary in order for El Paso to temper the continuing increases in its purchased gas costs and in its resale rates. El Paso has been and presently is engaged in intense competition in its major marketplace, California, with other gas suppliers and, in both its California and East-of-California markets, with alternate fuel sources such as oil and hydroelectric power. Since 1981, several factors have combined to decrease El Paso's sales levels by approximately thirty percent. These factors include unusually high precipitation (creating unanticipated and inordinately large quantities of cheap hydroelectric power), abnormally mild weather, depressed economic conditions generally (leading to plant shutdowns), conservation and declining prices of alternative fuels (resulting in fuel-switching). Although El Paso has substantial volumes of natural gas available for sale to its customers in the remaining, contracted market for gas, various causes beyond El Paso's control,

including the ratemaking policies of the California Public Utilities Commission and high minimum bills of other suppliers (particularly suppliers of Canadian gas), dictate that El Paso take all reasonable means to hold its existing resale rates (86.7 percent of which consists of purchased gas costs) essentially stable during the near-term future in order for El Paso to maintain its present share of the market and, importantly, to attempt to increase its market share. Failure to do so could jeopardize some 275 MMcf per day or more in sales volumes, an amount which equals approximately an eleven percent decline from expected levels.

There are three imminent threats to El Paso's ability to maintain or increase its sales levels:

- First, under many contracts for the sale of NGPA § 107 "deep" and "tight sands" gas, there is no effective provision whereby the price payable for such gas may be brought in line with gas supply and market demand realities. Accordingly, the prices being paid by El Paso under such contracts exceed by a substantial amount the current market value of such gas. The impact of these high-priced contracts on El Paso's gas costs is approximately $70 million per year, or about 8 cents per dekatherm in its resale rates.

- Second, because El Paso's sales levels have declined precipitously (approximately thirty percent) during the last two years, its level of takes from its various supply sources has also declined. In order to equitably apportion the reduced market, El Paso imposed a moratorium on new gas purchases in mid-1982 and has purchased dedicated gas ratably systemwide except where priority purchases are required by law. Because of the reduced takes, the potential for claims under take-or-pay clauses stands as a threat to the required stability of El Paso's resale rates. Current estimates translate such potential prepayment exposure into an effect on El Paso's rates of as much as 10 cents per dekatherm.

- Third, almost thirty percent of El Paso's supply will be freed from price regulation after December 31, 1984. Much of this gas is also covered by contracts that do not contain viable market-sensitive pricing provisions. Though the impact of the "fly-up" in prices is not amenable to precise calculation, El Paso's rates could increase by more than 50 cents per dekatherm upon deregulation on January 1, 1985, unless action is taken to make the applicable contracts more market-sensitive.

In addition to the foregoing factors, El Paso's resale rates are subject to the monthly ratcheting effect of NGPA price escalators, the effect of which is greatest as to NGPA § 102 gas. These escalators currently cause El Paso's gas costs to rise by some 15 cents per dekatherm each year.

El Paso has undertaken numerous efforts in an attempt to solve these problems. El Paso has selectively sought, both through requests for voluntary amendments and through individual negotiations, to obtain relief from the various contractual problems but has encountered only minimal success. El Paso has, on two separate occasions, exercised its contractual rights to reduce prices otherwise payable for NGPA § 107 gas under applicable contracts. The current Alternate Price under such contracts is $4.00 per MMBtu, plus taxes. El Paso prices its own "deep" gas production and that of its exploration affiliate at a level below this Alternate Price. In addition to these supply-related actions, El Paso continues in its efforts to stabilize and increase its market share. These efforts have involved not only numerous administrative proceedings before the Federal Energy Regulatory Commission, but also appearances before committees of the United States Congress and active participation in proceedings of the Energy Regulatory Administration and before the California Public Utilities Commission concerning the importation of natural gas from Canada. One recent event, at least partially attributable to these activities, was the settlement on a lower minimum bill between one of El Paso's major California customers and one of such customer's other suppliers. Though this event is cause for some hope, El Paso's market share will increase only to the extent its rates remain competitive with those of all other available suppliers. Finally, El Paso has attempted to develop programs intended to retain endangered markets, recover lost markets and secure new markets within its existing service area.

Despite these efforts, El Paso's market position remains threatened. El Paso is firmly committed to solving these problems so as to remain capable of marketing your gas. However, El Paso recognizes that the Alternate Price action described above is not the only solution to the existing state of its gas supply and market demand environment. Therefore, through this letter, El Paso offers you the opportunity to elect to receive a price (including any production-related cost or other add-ons) equal to $3.50 per MMBtu, plus taxes, for all NGPA §§ 102, 107 and 108 gas sold and delivered under the affected contracts, in return for your cooperation in making all gas purchase agreements between us more market-responsive. Accordingly, El Paso hereby tenders the attached Amendatory Agreement to you for your consideration. By executing said Amendatory Agreement, you will make a significant contribution to the solution of the above-described market problems by assisting El Paso in bringing in line with realities those contracts which are the primary cause of El Paso's current and anticipated marketing problems, which problems are shared by you.

Pursuant to the terms of the Amendatory Agreement, all gas purchase agreements between you and El Paso will be amended by (1) reducing any applicable minimum take-or-pay levels to 50% (for the period from January 1, 1982 through December 31, 1984) and 60% (from and after January 1, 1985); and (2) including (by addition or replacement) a

marketability provision. The take-or-pay reduction, of course, affects only gas-well contracts, and not contracts covering purchases of residue or casinghead gas. The marketability provision will, among other things, permit you to sell your gas to another buyer following any exercise by El Paso of its rights under that provision, permit you to obtain best efforts transportation of any gas so marketed through El Paso's system and assure you of El Paso's intent to treat all sellers evenhandedly. In addition, the Amendatory Agreement contains El Paso's agreement to forego any further exercise of its rights under the marketability provision through December 31, 1984.

If you determine to accept this alternative opportunity, please complete and execute the Amendatory Agreement and return it to El Paso at Post Office Box 1492, El Paso, Texas 79978; Attention: Gas Purchases Department. Within approximately 90 days after receipt of the executed Amendatory Agreement, El Paso will prepare and forward to you a listing of those specific contracts and wells which El Paso has determined will be affected by the Amendatory Agreement.

The offer extended in this letter and the attached Amendatory Agreement shall remain open through May 1, 1984. If the executed Amendatory Agreement is returned to El Paso postmarked not later than May 1, 1984, the price to be paid for all NGPA §§ 102, 107 and 108 gas deliverable under gas purchase agreements between you and El Paso will be $3.50 per MMBtu, plus taxes, beginning on May 1, 1984, unless a lower contract price is effective. Otherwise, the full price reduction to $3.00 per MMBtu, plus taxes, will be effectuated as of May 1, 1984 for all such gas under those contracts where the right to effect a price reduction exists.

Any questions you might have on this matter may be directed to El Paso's Gas Purchases Department at (915)541-5408.

Very truly yours,

EL PASO NATURAL GAS COMPANY

By _____
Michael C. Holland
Vice President

AMENDATORY AGREEMENT

THIS AMENDATORY AGREEMENT is made and entered into as of the 1st day of May, 1984, by and between EL PASO NATURAL GAS COMPANY, hereinafter referred to as "Buyer," and _____, hereinafter referred to as "Seller."

WHEREAS, Buyer and Seller are parties to one or more agreements for the purchase and sale of natural gas; and

WHEREAS, for valuable consideration known to the parties to be sufficient, Buyer and Seller now desire to amend all agreements existing between them as provided herein.

NOW THEREFORE, it is mutually agreed between the parties that effective as of the date hereof, all agreements between Buyer and Seller for the purchase and sale of natural gas shall be amended as follows:

I.

In the event El Paso is obligated to receive and pay for, or pay for whether or not received, a minimum quantity of gas under the take-or-pay provisions of any gas purchase agreement, and such take-or-pay obligation is in excess of the following levels, then such provisions shall be modified in each instance to specify a take-or-pay obligation equal to:

(a) for the period from January 1, 1982 through December 31, 1984, fifty percent (50%) of the aggregate daily producing ability of Seller's wells; and

(b) for the period from and after January 1, 1985, sixty percent (60%) of the aggregate daily producing ability of Seller's wells.

II.

Each gas purchase agreement between Seller and El Paso shall, unless such agreement presently contains an identical provision, be supplemented and amended to include the following provision in the "Price" article thereof:

"Notwithstanding any other provision of this Agreement, it is expressly understood and agreed that if at any time and from time to time either:

"(A) Pursuant to an order of the Federal Energy Regulatory Commission, its successor administrative agency or other governmental authority having jurisdiction, Buyer, for any reason, is not permitted or allowed to include in its filed rates the full price (including any adjustments or add-ons) paid Seller for all or any portion of gas delivered hereunder; or

"(B) Buyer, acting in good faith and in accordance with prudent business practices, determines, in its sole discretion, that its gas supply and market demand environment indicates a downward change in the value to Buyer of the gas to be purchased from Seller hereunder;

"Then, in either event, upon the giving of written notice to Seller specifying the gas involved, Buyer shall have the right to reduce the price otherwise payable hereunder for such gas to equal, as the case may be, either that price which Buyer is so permitted or allowed to include in its filed rates, or that price indicative of Buyer's then existing gas supply and market demand environment. Said reduced price shall become effective hereunder on the first (1st) day of the month following the month in which Buyer's notice hereunder is given.

"If the event specified in (A) above occurs, then Seller shall refund to Buyer, within ninety (90) days following the giving of Buyer's said notice, any amount paid to Seller that was not permitted or allowed to be included in Buyer's filed rates, with interest thereon calculated in accordance with Section 154.102(d) of the Regulations Under the Natural Gas Act, or succeeding interest provisions prescribed from time to time by the Commission, or successor governmental body.

"The reduced price specified by Buyer in any such notice given pursuant to the event specified in (B) above is hereinafter referred to as the 'Alternate Price.' Buyer and Seller agree that, at any time within sixty (60) days after the date of Buyer's notice specifying such an Alternate Price, Seller may elect, by giving written notice of such election to Buyer, to terminate this Agreement if it can sell the gas subject to such notice to another bona fide unaffiliated pipeline company which is ready, willing and able to purchase said gas at a price higher than the specified Alternate Price. In the event Seller elects to so terminate this Agreement, Buyer shall, at Seller's request, transport the gas affected by such termination on behalf of Seller or such bona fide unaffiliated pipeline company to a mutually-agreeable point on Buyer's pipeline system; provided that such transportation service shall be rendered at Buyer's gathering, processing, transportation and other applicable rates then on file with the Federal Energy Regulatory Commission (or any successor authority having jurisdiction), or otherwise published rates, as revised from time to time, and shall be conditioned upon the availability of capacity sufficient to provide such service without detriment or disadvantage to Buyer's customers and shippers with firm transportation rights.

"The purchase and sale of the gas subject to Buyer's notice given pursuant to the event specified in (B) above shall continue hereunder at the Alternate Price either for a period of thirty (30) days after the date of receipt by Buyer of Seller's termination notice, at which time this Agreement shall terminate as to such gas, or only for so long as Buyer, in its sole discretion, determines that the event specified in (B) above requires such an Alternate Price. If, at the time notice of termination is given in accordance with (B) above, there exists an outstanding deficiency payment pursuant to any minimum purchase obligation, then this Agreement shall continue in full force and effect until such time as either Buyer has received gas hereunder (without making payment therefor) having a value, calculated at the Alternate Price in effect at the time Seller's notice of termination is given, equal to the then outstanding deficiency payment, or Seller refunds to Buyer in cash the amount of such deficiency payment. On the first (1st) day of the month following the month in which Buyer determines that the event specified in (B) above no longer requires any Alternate Price, the last price that was in effect and payable for such gas under the terms of this Article shall become the price payable hereunder for such gas.

"Buyer represents to Seller that it will not serve an Alternate Price notice on Seller under the foregoing provisions of this Paragraph unless Buyer shall, in conjunction therewith, serve Alternate Price notices on other similarly situated sellers pursuant to similar provisions contained in other gas purchase agreements, by which notices Buyer would reduce the price or prices payable under such other agreements to a level indicative of the value to Buyer of the gas delivered under such agreements."

III.

As herein specifically amended and supplemented, each agreement shall continue in full force and effect in accordance with its terms and provisions. This Letter Agreement is subject to all present and future valid laws and valid orders, rules and regulations of duly constituted governmental authorities having jurisdiction.

IV.

El Paso and Seller agree that El Paso has given notice under the "Price" article of each of the gas purchase agreements between Seller and El Paso, as amended herein, of its determination to change the price (including production-related cost or other add-ons) otherwise payable under such agreements to $3.50 per MMBtu, plus taxes (unless a lower price is applicable) and that such price shall become effective as of May 1, 1984, and shall continue until further notice from El Paso, provided, however, that in any event, such price shall not be reduced by El Paso prior to January 1, 1985.

IN WITNESS HEREOF, the parties have caused this Amendatory Agreement to be executed in two (2) original counterparts, by their duly authorized officers, as of the day and year first set forth herein.

ATTEST:

EL PASO NATURAL GAS COMPANY
"Buyer"

_____ By_____

ATTEST:

_____
"Seller"

Taxpayer I.D. No._____
S.S. No. _____

_____ By_____

Exhibit II

CEILING AND MARKET PRICES

FROM JAN 1982 TO JULY 1987

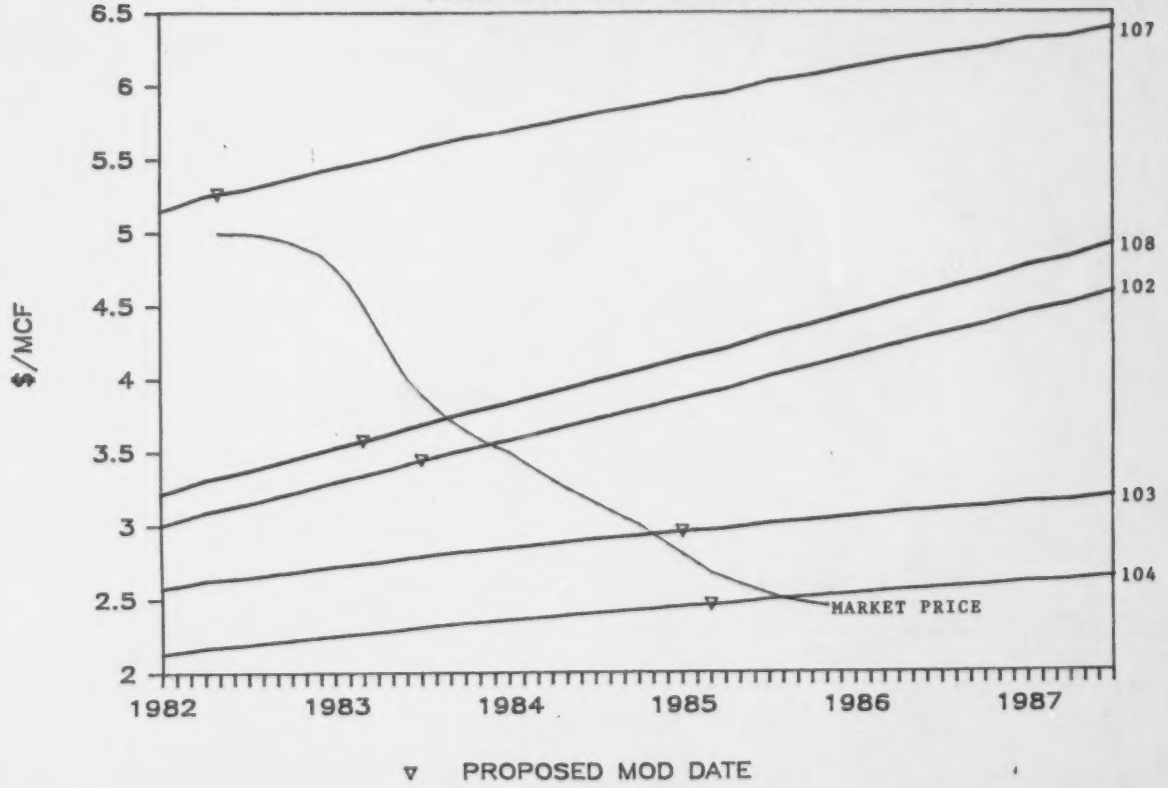

Exhibit III

ROYALTY AS PERCENTAGE OF PROCEEDS

BASED ON AVERAGE MARKET-OUT PRICES

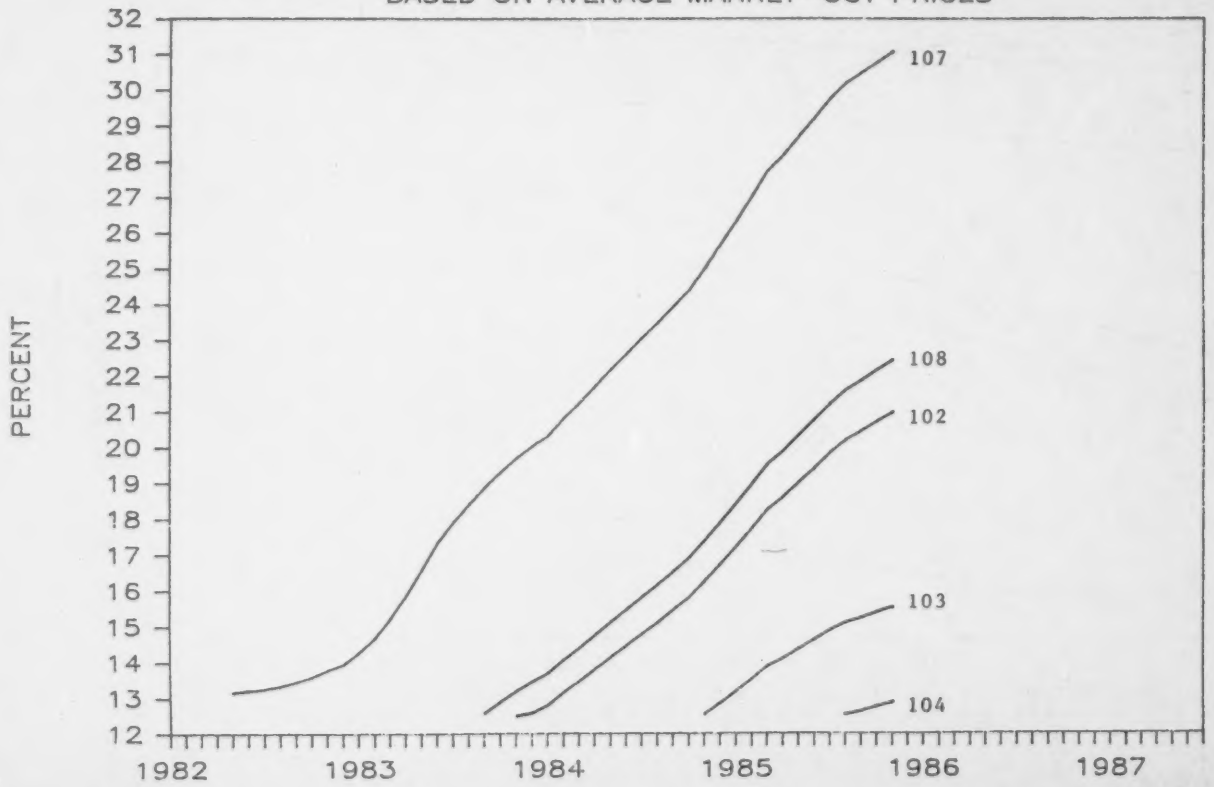

Exhibit IV

206.103 Value Basis for Computing Royalties.

The value of production, for the purpose of computing royalty, shall be the estimated reasonable value of the product as determined by the Associate Director due consideration being given to the highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessee, to posted prices, and to other relevant matters. Under no circumstances shall the value of production of any of said substances for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof or less than the value computed on such reasonable unit value as shall have been determined by the Secretary. In the absence of good reason to the contrary, value computed on the basis of the highest price per barrel, thousand cubic feet, or gallon paid or offered at the time of production in a fair and open market for the major portion of like-quality oil, gas, or other products produced and sold from the field or area where the leased lands are situated will be considered to be a reasonable value.

Exhibit V Attachment

United States Department of the Interior

OFFICE OF THE SECRETARY
MINERALS MANAGEMENT SERVICE
ROYALTY MANAGEMENT PROGRAM
P.O. BOX 5760
DENVER, COLORADO 80217-5760

IN REPLY REFER TO:

MMS-LC-L-NW

NOV 1985
RECEIVED
5-11-53

18 JAN 1983

Cotton Petroleum Corporation
ATTN: Purna Parsons
P.O. Box 3501
Tulsa, Oklahoma 74102

Dear Ms. Parsons:

We have checked with our Royalty Standards and Management Division and wish to inform you that the Minerals Management Service will honor the "economic-out-clause" in the gas sales contracts concerning NGPA Section 107 wells.

Also, MMS will recognize a fair and reasonable "arms-length" contract price that was established at a rate lower than the applicable NGPA Section ceiling price.

If you have any questions concerning this, or other matters, please contact Dave Menard at 1-800-525-0306.

Sincerely,

James R. Detlefs, Chief
Lessee Contact Branch

United States Department of the Interior

MINERALS MANAGEMENT SERVICE
RESTON, VA. 22091

In Reply Refer To:
EMS-Mail Stop 660

AUG 4 1983

Ms. Jennifer A. Cates
Attorney
Phillips Petroleum Company
1297 Adams Building
Bartlesville, Oklahoma 74004

Dear Ms. Cates:

This is in response to your letter of July 25, 1983.

The Minerals Management Service (MMS) is now in the process of issuing regulations and product value guidance implementing a Secretarial decision concerning valuation for royalty calculation purposes, of natural gas sold under the terms of an arm's-length contract.

MMS will accept gross proceeds received under a properly negotiated arm's-length contract as the basis for calculating royalties on gas produced on Federal leases.

The Payor's Handbook will be revised to reflect this new policy.

Sincerely,

Robert E. Boldt
Associate Director for
Royalty Management

PHILLIPS PETROLEUM COMPANY
BARTLESVILLE, OKLAHOMA 74004 918 661-6600

LEGAL July 25, 1983

Mr. Robert E. Boldt
Associate Director for Royalty Management
Department of the Interior
Minerals Management Service
18th and C Street, N.W.
Room 4226
Washington, D.C. 20240

Dear Mr. Boldt:

The purpose of this letter is to follow up our telephone conversation of July 25, 1983.

As discussed, we understand that for purposes of Federal leases, other than Indian leases, the policy which has been announced by the Service is to accept gross proceeds received under an arm's length contract as the proper valuation for royalty purposes.

We also understand that we may implement this policy immediately and that the Service will accept royalties paid in accordance with the policy notwithstanding the existence of instructions to the contrary contained in the current version of the Payor Handbook.

Please confirm that the foregoing accurately states the Service's policy or provide a correct statement if this is in error. Thank you for your attention to this request.

Sincerely yours,

Jennifer A. Cates

Jennifer A. Cates
Attorney for
Phillips Petroleum Company
1297 Adams Building
Bartlesville, OK 74004
Phone: (918) 661-8372

JAC/va

United States Department of the Interior
OFFICE OF THE SECRETARY
MINERALS MANAGEMENT SERVICE
ROYALTY MANAGEMENT PROGRAM
P.O. BOX 5760
DENVER, COLORADO 80217-5760

IN REPLY REFER TO:

MMS-RVS-OG
MS-653

30 NOV 1983

Ms. Jan E. Potts
Home Petroleum Company
One Denver Place
999 18th St., Suite 801
Denver, Colorado 80202

Dear Ms. Potts:

You advise that despite Home Petroleum Company's best efforts, it cannot, at this time, sell its gas at the maximum allowable NGPA price.

You ask whether MMS will accept your arm's-length contract price as value for royalty purposes though it is less than the maximum NGPA allowable price. The answer is yes.

Sincerely,

William H. Feldmiller

William H. Feldmiller
Chief, Royalty Valuation and
Standards Division

United States Department of the Interior

MINERALS MANAGEMENT SERVICE
RESTON, VA. 22091

IN REPLY
REFER TO:
LMS-Mail Stop 660

DEC 5 1984

Cities Service Oil and Gas Corporation
Attention: Mr. R. W. Bruce
P.O. Box 300
Tulsa, OK 74102

Dear Mr. Bruce:

By letter of November 7, 1984, you posed a number of questions regarding natural gas royalty valuation issues. We will answer your inquiry by first stating general Minerals Management Service policies and then responding to each of your individual questions.

Take-or-Pay Provisions

MMS considers a take-or-pay payment to be any benefit received by a lessee pursuant to a take-or-pay clause in its gas purchase contract. Payments of money or other types of renumeration made by a gas purchaser to a lessee pursuant to a contractual take-or-pay provision are considered as advance payments which are subject to royalty in accordance with the gross proceeds requirements of the regulations. Royalty is due on the value or amount of take-or-pay renumeration received by the lessee. If the buyer subsequently "makes-up" the take-or-pay payment, no royalty is due until the dollar value of the take-or-pay royalty payment is recouped (note: it is the dollar value of the payment that may be recouped--not, for instance, the volume or number of Btu's of take-or-pay gas involved.)

Royalty is also due on the amount of any take-or-pay payment made to a lessee pursuant to a take-or-pay settlement agreement. Even if the contractual make-up period has expired, royalty is due because such payment constitutes gross proceeds accruing to the lessee. A case could arise where a take-or-pay settlement amount is less than the amount of the take-or-pay payment specified in the gas purchase contract, and the lessee had already paid royalty on the contractual amount. In this situation the lessee may apply to MMS for reimbursement of the difference between these two amounts.

If a take-or-pay settlement agreement involves a price reduction, royalty on the reduced price, if reached under arm's-length conditions, generally would be acceptable for royalty purposes. Any settlement reached under non-arm's-length conditions must be presented to MMS for approval.

Gross Proceeds

Under no circumstances can value for royalty purposes be less than the gross proceeds which accrue to the lessee. MMS considers gross proceeds to include, but not be limited to, payments to the lessee for certain services, such as compression, dehydrating, measuring and/or field gathering to the extent that the lessee is obliged to perform them at no cost to the Federal Government or Indian lessor; payments for gas processing rights; take-or-pay payments; reimbursement for harboring or terminalling fees; and tax reimbursements. Tax reimbursements are considered as part of gross proceeds accruing to a lessee even though the Federal royalty interest is exempt from taxation.

Market Out Clauses

MMS generally will accept royalty payment based on "market out" values provided the lessee can demonstrate that other producers of like-quality gas in the same field or area are being subjected to similar market out value reductions under their arm's-length contracts. In the event that market conditions change to allow an increase in gas prices, MMS expects the lessee to move immediately to get the higher price. MMS, in all cases, reserves the right to establish a value for the gas should the lessee not meet the requirements of the regulations.

Prudent and Workman-Like Operation

MMS expects lessees to conduct operations in a prudent and workman-like manner. The lessee is expected to make good business decisions for the benefit of its Federal or Indian lessor. Lease operations are expected to be conducted, and decisions made, in that manner which satisfies the best interests of both the lessee and the lessor. If a lessee were to enter into special arrangements which satisfy its own interests but are detrimental to the Federal or Indian lessor interests, MMS would be required to take appropriate action to protect the lessor's interest including the establishment of value for royalty purposes. This type arrangement would not be considered one made in the open market under arm's-length conditions. If a lessee, for any reason, fails to make proper and timely application for payments or reimbursements to which it is entitled, MMS has the responsibility to see that the Federal Government or Indian lessor shall not suffer a loss and will bill royalty due with a late payment penalty, if appropriate. However, when a lessee does make proper and timely application for payments or reimbursements to which it is entitled, royalties are not due until the lessee receives payment.

Answers to Questions Posed

Following are answers to your specific questions. It is hoped that these answers, together with the preceding general information, will fully apprise you of MMS policy. All answers are based on the premise of arm's-length situations. An arm's-length contract is one that has been freely negotiated

in the open market place between independent, non-affiliated parties of adverse economic interests not involving any consideration other than the sale and transportation of the gas, and/or gas products and prudently negotiated under the facts and circumstances existing at the time.

Question "A. Generally speaking, how does Minerals Management Service intend to determine the amount due? Is it on monies actually received as opposed to billed? Specifically,

"(1) If a pipeline unilaterally refuses to pay take-or-pay amounts billed, thus requiring the producer to either (i) seek relief in court in a lengthy lawsuit [in which the pipeline will raise defenses of force majeure (loss of Market) and that such payments exceed NGPA ceiling prices and other similar defenses], or (ii) settle the claim, may a producer settle the take-or-pay claim for a lesser amount than that billed and pay royalty on the settlement amount?"

Answer MMS will normally accept royalty payment based on the amount actually received. As stated earlier, the lessee is expected to act in a prudent and workman-like manner making good business decisions which benefit himself and the Federal or Indian lessor.

In general, the lessee may pay royalty based on the best arm's-length take-or-pay settlement it is able to negotiate. If the settlement involves a reduced price, such price would be acceptable for royalty purposes subject to possible future audit and the possibility that MMS may establish value for royalty purposes if the settlement is determined to be other than arm's-length.

Question "(2) Under the same set of facts, may a producer settle the take-or-pay claim by agreeing to receipt of payment of the full amount of take-or-pay owed in exchange for (1) reduced takes for the future, or a limited period of time and/or (b) price reduction for the future or a limited period, and thereafter pay royalty on the reduced price?"

Answer Yes.

Question "(3) May a producer waive past take-or-pay, grant a reduced price or reduced takes on one lease in exchange for connection of, or greater takes or other benefit on another Federal lease?"

Answer Yes, provided any transfer of benefits involves only Federal leases at the same royalty rate, or Indian leases (from the same Tribe only) at the same royalty rate. No transfer can occur between allotted Indian leases.

Question "(4) (a) If a pipeline threatens to unilaterally breach a take or pay obligation or contract price provision by unilat-

erally reducing takes or price or by taking no gas unless a producer agrees to amend the contract to reduce the price and/or waive past takes or pay, thus leaving the producer with the alternative of no takes pending a lengthy and highly contested lawsuit, may a producer execute such an amendment and pay royalty under the same?"

Answer Yes.

Question "(b) Is the answer any different if under the same set of facts the producer executes the amendment while the other working-interest owners do not, thus entitling the latter to a higher price and subsequent events reveal the pipeline never reduces the takes from those owners who did not execute the amendment?"

Answer No. Continue to keep in mind, however, the lessee's obligation to make prudent and workman-like decisions that are considered to be in the best interests of both the lessee and the Federal and Indian lessor.

Question "(c) Is the answer to 4(a) any different if the amendment executed by producer also contains a temporary reduction in the take obligation?"

Answer No.

Question "(5) On several occasions a pipeline who has a legitimate market out provision in its contract will forward a notice to the producer whereby the pipeline offers several price alternatives. For example, one price may be offered if producer agrees to certain conditions, such as reduction of future takes or waiver of past sums due. A lesser price may be offered without such conditions. If producer chooses one alternative over the other, for example the lesser price without conditions, may he pay royalty on that amount? What if other working-interest owners select the other alternative?"

Answer The producer may pay royalty on the amount resulting from the alternative chosen. The other working-interest owners will pay royalty on the basis of the alternative they select. As stated earlier, this assumes that all arrangements are arm's-length, prudent and workman-like.

Question "II. Deregulated Gas

"(A) What is Minerals Management Service's position toward royalty payment on gas which may be deregulated because of its NGPA category but which will not receive a deregulated price (assuming the latter to be higher) because the pipeline contract did not contain a deregulation clause?"

Answer MMS will accept royalty on the price received.

Question "(B) Where the contract does contain a deregulation formula, which results in a price higher than the pipeline will pay, if the pipeline unilaterally refuses to pay such price, the alternative again being a lawsuit, may the producer agree to a lower price?"

Answer Yes.

COGS

Question "(1) As you are aware, Cities Service has received approval from the Federal Energy Regulatory Commission for the release of gas from interstate pipelines who are in an oversupply situation and for the subsequent sale of that gas at a cheaper price to end use markets. This program is known as the 'Consumer Oriented Gas Sales Program.' Within the guidelines set up by the FERC, may Cities sell gas under the COGS program and pay royalty to Minerals Management Service on the price received from the end use customer?"

Answer Yes.

Question "(2) As part of the COGS program Cities is often required to use existing gas pipeline facilities for transportation to the end user and to pay the pipeline its tariff rate for such transportation. May Cities deduct the cost of such transportation from the proceeds received from the end user, as it is impossible to serve such an end user without payment of transportation fees?"

Answer If these transportation costs will not be paid by the end user, they may be deducted from royalty payments. However, Cities must submit a transportation deduction request to MMS for review and approval prior to claiming it.

We hope that this information is helpful and responsive to your needs.

Sincerely,

Robert E. Boldt
Associate Director for
Royalty Management

United States Department of the Interior
MINERALS MANAGEMENT SERVICE
ROYALTY MANAGEMENT PROGRAM
P.O. BOX 25165
DENVER, COLORADO 80225

IN REPLY
REFER TO:

MMS-RVS-OG:84-1022
M.S. 653

DEC 21 1984

Mr. Walter S. Fees, III
2516 Foresight Circle, Room 10
Grand Junction, CO 81505

Dear Mr. Fees:

This is in response to your letter of December 5, 1984, in which you requested the Minerals Management Service's position on valuing, for royalty purposes, gas that is sold at less than NGPA ceiling prices. You specifically addressed the agreement with WestGas whereby prices received for Sections 102 and 103 gas from Dakota wells in the Hunters Canyon Unit will be reduced to $3.25 and $2.73 per Mcf, effective January 1, 1985. All onshore Section 102 gas and Section 103 gas produced below 5000 ft will be deregulated on January 1, 1985.

The Minerals Management Service will accept prices negotiated under arm's-length contract as the fair-market value basis for royalty computation. Therefore, you should compute and pay royalties based on prices received under your arm's-length contract with WestGas. Should you receive any reimbursements or other remuneration for sale of the subject gas, then you are to calculate and pay royalties based on your accrued gross proceeds pursuant to Title 30, Code of Federal Regulations, Part 206.103.

If you have any questions regarding this matter, please phone (303) 231-3534.

Sincerely,

William H. Feldmiller

William H. Feldmiller
Chief, Royalty Valuation and
Standards Division

Exhibit VI

FILE COPY
Surname:

United States Department of the Interior

OFFICE OF THE SOLICITOR
WASHINGTON, D.C. 20240 ... ..

MAY 16 1985

Attorney-Client Communication
Privileged and Confidential

MMS.ER.0185

Memorandum

To: William D. Bettenberg, Director
Minerals Management Service

From: Lawrence J. Jensen
Associate Solicitor, Energy and Resources

Subject: Lease Terms and Regulations Governing Valuation of Union Oil Company's Natural Gas Production in the Kenai Unit

This memorandum is in response to your request for legal guidance regarding MMS' authority to establish value for royalty purposes of Union Oil Company's natural gas production in Alaska's Kenai Unit.

I. Union's Leases

Union owns approximately an undivided 50% working interest in seven Federal oil and gas leases in the Kenai Unit: A-028047, A-028055, A-028056, A-028103, A-028140, A-028142, and A-028143 (hereinafter, the "Federal Leases"). Marathon Oil Company owns the other undivided 50% working interest in the Federal Leases.

Pursuant to the terms of its leases, Union is required to pay the lessor 12 1/2 percent royalty on any oil and gas production removed or sold from the leased lands. Because of conveyances of certain lands to Cook Inlet Region, Inc. ("CIRI")[1/] pursuant to

---

1/ CIRI is one of twelve Alaska Native Regional Corporations established by Congress under the Alaska Native Claims Settlement Act (ANCSA). Pursuant to Section 7(i) of ANCSA, 43 U.S.C. § 1606(i), and the Section 7(i) Settlement Agreement dated June 29, 1982, which was approved by the United States District Court for the District of Alaska on June 3, 1983, see Aleut Corp., et al. v. Arctic Slope Regional Corp., et al., Civil No. A75-53 (D. Alaska), seventy percent (70%) of CIRI's annual net revenues from the subsurface estate conveyed to it under ANCSA is subject to sharing among the twelve Native Regional Corporations.
(footnote continued)

provisions of the Alaska Native Claims Settlement Act, 43 U.S.C. § 1601 et seq., CIRI is entitled to approximately 65% of the royalties from oil and gas produced from the Federal Leases, with the remaining 35% going to the Federal Government.2/ Section 14(g) of ANCSA, 43 U.S.C. § 1613(g), requires the United States to retain administration of CIRI's interests in the Federal Leases, "unless the agency responsible for administration waives administration."

II. The Secretary of the Interior's Authority to Establish the Value of Production for Purposes of Computing Royalty

The Mineral Leasing Act (MLA), 30 U.S.C. § 181 et seq., and the regulations and leases issued thereunder, reserve to the Secretary of the Interior ("Secretary") broad discretion to establish the value of oil and gas for royalty purposes, and to establish terms and conditions for the payment of such royalties. See, e.g., Continental Oil Company v. United States, 184 F.2d 802, 821 (9th Cir. 1950); California Co. v. Udall, 296 F.2d 384 (D.C. Cir. 1961); Marathon Oil Co. v. United States, ___ F. Supp. ___, Civ. No. A83-208 (D. Alaska, decision filed Feb. 20, 1985).

Section 17 of the MLA, 30 U.S.C. § 226, provides that for onshore oil and gas leases the royalty "shall be not less than 12 1/2 per centum in amount or value of the production removed or sold from the lease." The Secretary's authority to issue regulations and orders regarding the determination of value for Federal lease production is expressly set forth in Section 32 of the Mineral Leasing Act, 30 U.S.C. § 189, which authorizes the Secretary "to prescribe necessary and proper rules and regulations and to do any and all things necessary to carry out and accomplish the purposes of [the Act] . . . ." Such regulations have the force and effect of statutes when not inconsistent with or repugnant to the statute in question. See, e.g., California Company v. Seaton, 187 F. Supp. 445, 449 (D.D.C. 1960), aff'd sub nom. California Co. v. Udall, 296 F.2d 384 (D.C. Cir. 1961).

(footnote continued from previous page)
Thus, the other eleven Regional Corporations have a right to receive a percentage of the overall annual net revenue stream generated from subsurface resource development on lands conveyed to CIRI under ANCSA. Accordingly, any royalty payments which CIRI receives from Union on gas production from the Federal Leases is included in CIRI's gross subsurface revenues in calculating the amounts subject to sharing among the Alaska Native Community pursuant to Section 7(i) of ANCSA.

2/ Pursuant to Section 35 of the Mineral Leasing Act, 30 U.S.C. § 191, the State of Alaska is entitled to 90% of the royalties received by the United States from the Federal Leases. The State also owns non-Federal leases in the Kenai Unit from which it and CIRI are entitled to royalties from Union.

The Federal Leases themselves further define the breadth of the Secretary's authority to establish the royalty value of oil and gas produced from the leases. The initial paragraph of each of the Federal Leases provides that the lessee "offers to lease . . . the lands . . . subject to the terms and provisions of the [Mineral Leasing] act, and all reasonable regulations of the Secretary of the Interior now or hereafter in force." Under Paragraph 2(d)(1) of the Federal Leases, moreover, Union, as lessee, is required to pay the lessor "12 1/2 percent royalty on the production removed or sold from the leased lands computed in accordance with the Oil and Gas Operating Regulations (30 C.F.R. Part 221)." Finally, under Paragraph 2(d)(2) of the Federal Leases, Union has "expressly agreed that the Secretary of the Interior may establish reasonable minimum values for purposes of computing royalty on . . . gas" removed or sold from the leased premises. Such provisions are valid under the statute. See, United States v. Ohio Oil Co., 163 F.2d 633 (10th Cir. 1936).

III. MMS Regulations Governing Gas Royalty Valuation

A. Royalty Value Regulations in 30 CFR

The Oil and Gas Operating Regulations which are referenced in the Federal lease forms, and which were promulgated pursuant to the MLA in 1942, are now codified at 30 C.F.R. § 206.103 (formerly 30 C.F.R. § 221.47). The first sentence of this regulation provides that "The value of production as determined by the Associate Director [for Royalty Management, MMS, the Secretary's delegate] shall be the estimated reasonable value of the product . . . due consideration being given to the highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessee [e.g. contract price] . . . and to other relevant matters." (Emphasis added.) The District Court in Marathon Oil Co. v. United States, supra, determined that this provision confers upon MMS broad discretion in valuing gas for royalty purposes.

The second sentence of the regulation provides the only specific requirement: "Under no circumstances shall the value . . . be less than the gross proceeds accruing to the lessee . . . ." In all instances, therefore, gross proceeds is a minimum royalty value.

The regulation's last sentence defines to some extent the broad discretion conferred by the first sentence. It provides that:

> In the absence of good reason to the contrary, value computed on the basis of the highest price per . . . thousand cubic feet . . . paid or offered at the time of production in a fair and open market for the major portion of like quality . . . gas . . . produced and sold from

> the field or area where the leased lands are situated will be considered to be a reasonable value. (Emphasis added.)

Thus, unless there is "good reason to the contrary," the minimum royalty value under this regulation for all gas produced from the lease could be the value computed in a major portion analysis including sales from the entire area, not just a field. Of course, if gross proceeds for any gas sale yields a higher value, that is the appropriate measure of value.

B. NTL-5

The Oil and Gas Operating Regulations periodically have been supplemented by Notices to Lessees (NTL) imposing certain obligations on lessees and operators. NTL-5 was promulgated in 1977 after issuance of a proposed NTL and opportunity for comment. Although NTL-5 does not appear in the Code of Federal Regulations (CFR), it nonetheless is a rule within the meaning of the Administrative Procedure Act (APA), 5 U.S.C. § 551. Consequently, the agency is bound to enforce the terms of the rule as promulgated, and is not free to ignore those provisions in favor of a different standard.3/ See discussion below.

It is evident from the initial clause of NTL-5 that its provisions were intended to be consistent with, not in derogation of, the fundamental royalty valuation regulation quoted above. The NTL begins: "This Notice is issued pursuant to the authority prescribed in the Oil and Gas Operating Regulations, 30 C.F.R. § 221 [now 30 C.F.R. § 206.103], which provide in part . . . ." It then quotes the entire royalty value regulation in 30 CFR. NTL-5 therefore essentially constitutes an agency statement as to how the authority in 30 C.F.R. § 206.103 will be exercised in prescribed circumstances.4/

3/ The APA, 5 U.S.C. § 553, distinguishes between the more usual "legislative" rule and "interpretative" rules. If a rule is considered only to be interpretative, then it is useful for guidance but is not binding on the agency in all circumstances. Based upon our review of the language of NTL-5, coupled with the fact that it was published in the Federal Register for comment, we conclude that NTL-5 should be considered a legislative rule binding on the agency.

4/ It is our understanding from MMS that your current policy is to use NTL-5 for valuing natural gas produced from Federal onshore and Indian leases and as a basis for conducting lessee audits. A number of enforcement actions premised on NTL-5 currently are pending. We further understand that any new product value regulations would be applicable prospectively from the date the new rules are issued.

1. Determination of "Base Values"

Section II of MTL-5 is applicable to Kenai Unit production because that section applies to intrastate and other sales not subject to FPC (now FERC) jurisdiction. Subsection II.A., "Establishment of Royalty Value," basically distinguishes between only two classifications of gas sales for royalty value purposes:

> (1) sales pursuant to arm's-length contracts entered into prior to June 1, 1977, but only for gas from wells commenced prior to that date; and
>
> (2) all other sales or dispositions, which include: (a) sales pursuant to any arm's-length contracts entered into on or after June 1, 1977; (b) sales pursuant to arm's-length contracts entered into prior to June 1, 1977, to the extent they include gas sales from wells commenced on or after that date; (c) sales pursuant to arm's-length contracts renegotiated on or after June 1, 1977; and (d) all sales not involving an arm's-length contract.

Section II.A.1. prescribes that the base value[5/] for gas in the first classification, i.e., pre-June 1977 contracts for pre-June 1977 gas, is the higher of the contract price or at least 18 cents per Mcf. Section II.A.2. of MTL-5 prescribes that the base value for gas in the second classification is the higher of contract price or the price paid or offered for a major portion of like quality gas produced in the field or area (or if a major portion analysis cannot be calculated or does not reflect a reasonable value, value is determined as the highest applicable FERC rate for the same vintage gas).

Subsection II.A. of MTL-5 leaves no discretion -- the values for the two categories of sales must be determined as prescribed. However, as discussed more fully below, the determination procedure may vary from case to case.

2. Redetermination of base values

After the value for gas is determined initially pursuant to subsection II.A. of MTL-5, subsection II.B. provides that the base value "shall be redetermined . . . whenever necessary to

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5/ MTL-5 uses the term base value because section III of MTL-5 provides for a quality adjustment, and value must be increased by such factors as reimbursed state severance taxes consistent with the gross proceeds clause of 30 C.F.R. § 206.103 and subsection V.A. of MTL-5.

reflect market conditions." The redetermination therefore is mandatory if there are changed market conditions. MMS has some discretion to determine whether market conditions have changed sufficiently to warrant redetermination, as NTL-5 establishes no standard on this subject. If MMS makes the prerequisite finding of changed conditions, the redetermined value is to be based on the higher of the escalated contract price received or receivable by the lessee (if applicable), or the highest price paid for a major portion of like quality gas produced in the field or area (with the same proviso to use the highest comparable FERC rate if a major portion analysis is not practicable).

The result is that where market conditions change, redetermination of values is required, except, as explained below, MMS is not required to revalue gas where the lessee's sales contract does not have a pass-through provision (or the contract does not otherwise provide for price increases). In some cases, redetermination will result in values for pre-June 1977 gas sold under pre-June 1977 contracts being raised from the contract price to the price paid for a major portion, the same value used for gas sold under non-arm's-length contracts and for other sales in the second category of section II.A. of NTL-5.

There is no question that the redetermination provision was intended to apply to sales under long-standing arm's-length contracts which are in the first classification discussed above. The last paragraph of the redetermination provision in subsection II.B. provides that:

> Any readjusted base value for sales from wells commenced prior to June 1, 1977, and which are subject to an arm's-length contract made pursuant to contract entered into prior to that date, will consider the extent to which the lessee or operator is entitled to collect a higher rate pursuant to the provisions of the applicable contract.

(Emphasis added.) Thus, the redetermination clause is expressly applicable to these long-standing arm's-length contracts.

The above-quoted paragraph also makes it clear that application of the readjusted value is not automatic -- MMS must consider whether the lessee could pass on additional royalty obligations to, or otherwise collect a higher rate from, the buyer under the sales contract. If not, MMS would not be required to revalue.

3. Effective Dates for Redeterminations

Subsection II.C. of NTL-5 establishes effective dates for initial base value determinations and for redeterminations. Initial base value determinations were to be made effective as of the date of

first production or June 1, 1977, whichever is later. Redeterminations in accordance with escalation provisions of a gas sales contract are effective on the date specified in the contract. Finally, subsection II.B. redeterminations of value are effective "the first day of the month next following the month in which changing market conditions warrant a redetermination under this provision." Consequently, by its express terms, NTL-5 contemplates retroactively effective redeterminations based on changes in market conditions.

Because NTL-5 was published in the Federal Register, all lessees are deemed to have notice of all its provisions, including what gas may be revalued and the effective dates for initial determinations and redeterminations. 44 U.S.C. § 1507.

IV. Application of the Product Value Regulations and NTL-5 to Union's Kenai Unit Production

As shown previously, the Mineral Leasing Act, 30 U.S.C. § 189, authorizes the Secretary to issue the regulations in 30 C.F.R. § 206.103 and the NTL-5 rule to accomplish the purposes of the Act. The courts have held that such regulations have the force and effect of statutes when not inconsistent with or repugnant to the enabling statute in question. California Company v. Seaton, supra; Chevron U.S.A. v. Natural Resources Defense Council, ___ U.S. ___, 104 S.Ct. 2778 (1984); Chapman v. Sheridan-Wyoming Coal Co., 338 U.S. 621, 629 (1950) (a regulation promulgated pursuant to the Mineral Leasing Act has the force of law).

A well-established corollary principle is that an agency is bound to comply with its own regulations. See, e.g., United States ex rel. Accardi v. Shaughnessy, 347 U.S. 260 (1954); United States v. Nixon, 418 U.S. 683 (1974); Vitarelli v. Seaton, 359 U.S. 535 (1959); and Service v. Dulles, 354 U.S. 363 (1957). Consequently, valuation of Union's Kenai Unit gas production must be in accord with both 30 C.F.R. § 206.103 and NTL-5. MMS cannot simply choose to ignore the provisions of either rule.

Union's contracts for the disposition of gas fall into three categories: Pre-1977 arm's-length contracts (APL-I and City of Kenai[6/]); non-arm's-length contracts for sale to Collier Chemical Co., a wholly-owned Union subsidiary (Collier I and Collier II);

6/ APL-II, executed in December 1982, also is an arm's-length contract for gas from the Kenai Unit. However, Union did not actually take any Kenai Unit production for this contract until August 1984. It likely has calculated and paid royalties since then at a value which should not require a demand for additional royalties. Hence, revaluation of these volumes will not be considered further in this memorandum.

and a contract for rental of gas to Chevron for use in crude oil production. Applying NTL-5 to these contracts is relatively straightforward.

A. Value of Gas Sold Pursuant to Pre-June 1977 Arm's-Length Contracts

1. Initial Base Value

The only gas which would fit into the first of the two categories in subsection II.A. of NTL-5 discussed in the previous section is gas sold pursuant to the APL-I and City of Kenai contracts (pre-June 1977 contracts) to the extent that the gas is from pre-June 1977 wells (MMS projects the current volume of production from pre-June 1977 wells at approximately 75% of the total Kenai Unit production; the percentage is higher for months closer to June 1977). Under NTL-5 this gas has an initial base value of the higher of the contract price or at least 18 cents per Mcf. In all months since June 1977, the contract prices for APL-I and City of Kenai have exceeded 18 cents per Mcf, thus contract price is the initial base value. Pursuant to subsection II.C., this base value is effective June 1, 1977.

2. Redetermination of Base Value

As discussed above, the initial base value must be redetermined pursuant to subsection II.B. of NTL-5 where necessary "to reflect market conditions," and that redetermination is retroactive to the date market conditions changed. In the Marathon case, supra, MMS established that market conditions changed in the Cook Inlet Area in December 1982. On that date, Marathon and Union executed the APL-II contract at a price of $2.32 per Mcf (subject to adjustment). Consistency demands that MMS adopt, at a minimum, the same position on changed market conditions with regard to Union's production. A redetermination of value retroactive at least to January 1983 therefore is required by NTL-5 for these volumes. Moreover, if it can be established that there were other significant changes in market conditions between June 1977 and December 1982, the redetermination would be retroactive to those dates.7/

The APL-I and City of Kenai contracts do not have price escalators or other provisions which allow for renegotiation (except for an excess royalties clause discussed below). Thus, pursuant to subsection II.B. of NTL-5, the redetermined value

7/ Around January 1980, there were significant increases in the price paid for Cook Inlet area gas under the Phillips-Tesoro contract (an arm's-length contract not for Kenai Unit gas) and the Marathon/Phillips LNG contract. Prior to this date, there do not appear to be any dramatic changes in the market after June 1977.

would be based on the highest price paid for a major portion of like quality gas produced in the field or area. Computation of the highest price paid for a major portion presents several issues which are addressed below in the discussion of the NTL-5 value for the second category of contracts (e.g. non-arm's-length contracts).

As noted in the previous section, even if the value redetermined pursuant to subsection II.B. is higher than the contract price, it does not automatically become effective as the basis for royalty. Subsection II.B. provides that the redetermined value "will consider the extent to which the lessee or operator is entitled to collect a higher rate pursuant to the provisions of the applicable contract." However, the APL-I contract includes a provision allowing Union to pass through to the purchaser excess royalties. This clause certainly mitigates strongly in favor of adoption of the higher value.8/

The City of Kenai contract does not have an excess royalty clause. Consequently, the last paragraph of subsection II.B. suggests that MMS should not revalue this contract.

If MMS seeks to enforce an order retroactively establishing higher values for gas sold to APL-I or the City of Kenai, Union likely will argue that MMS should be estopped from such a retroactive change. The thrust of Union's argument will be that when USGS "accepted" the contract prices in 1978 in response to Union's filing an Application for Establishment of Royalty Value (Form 9-1926), it was bound to maintain that value until MMS notified it of a prospective change. Union's position is not persuasive. First, it is clear from the terms of NTL-5 that USGS created a structure whereby base values would be determined initially pursuant to subsection II.A., subject to redetermination pursuant to subsection II.B.9/ Moreover, NTL-5 explicitly provides that redeterminations are mandatory and are retroactive. Consequently, the NTL-5 rule requires retroactive redetermination. The case law has uniformly held that where a statute or MMS rule requires establishment of a royalty value higher than

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8/ NTL-5 leaves some discretion to MMS on this matter because it requires only that MMS "consider" the extent to which the lessee can pass through excess royalties or otherwise obtain higher prices from the buyer. It does not prescribe a result to follow from that consideration. However, in this case, the presence of the excess royalties clauses coupled with the mandatory redetermination procedures would appear to require adoption of the higher value.

9/ This construction of NTL-5 is reinforced by a review of the proposed NTL, 40 Fed. Reg. 54,268 (Nov. 21, 1975), which provides for initial determinations of value and then requires regular

what was paid and reported by the lessee, the agency may retroactively collect that additional royalty. Marathon v. United States, supra; Monsanto Company v. Watt, Civ. No. 81-4013 (D. Idaho, decision filed March 8, 1985); Atlantic Richfield v. Hickel, 432 F.2d 587, 591-592 (10th Cir. 1970) ("the United States may not be estopped from asserting a lawful claim by the erroneous or unauthorized actions or statements of its agents or employees . . ."); Marathon Oil Company, 16 IBLA 298, 81 I.D. 447, 454 (1974) ("The government is not . . . estopped from receiving royalty payments it is owed, even where the lower payments have been accepted in the past, unless the lower payments are authorized"); Supron Energy Corp., 46 IBLA 181 (1980); Amoco Production Co., 85 IBLA 121 (1985). Courts are "very reluctant to apply estoppel against the government in cases involving rights to public land . . . ." Union Oil Co. of California v. Morton, 512 F.2d 743, 748 n.2 (9th Cir. 1975). As noted previously, the so-called acceptances were nothing more than the initial value determinations required by NTL-5. Hence, Union should have anticipated redeterminations pursuant to NTL-5 when market conditions changed. But, even assuming that USGS "accepted" certain values, those values are not "authorized" and MMS may retroactively recover additional royalties based on values required by rule.

B. Value of The Remainder of Union's Share of Kenai Unit Production

The rest of the Union flow, excluding the volumes of rental gas, are subject to valuation in the second classification discussed in an earlier section. This includes gas volumes from the APL-I and City of Kenai contracts which are from wells commenced after June 1, 1977, and the Collier volumes. Subsection II.A.2. of NTL-5 establishes the value for these volumes as the higher of the contract price or "the highest price paid or offered for a majority of like quality gas produced in the field or area . . . ." Since a major portion analysis can be done here, the proviso for using a FERC rate instead is inapplicable. Because of the relatively few contracts, and because some contracts have disproportionately large volumes, how the major portion analysis is computed will affect the resulting value.

1. The Major Portion Analysis

The major portion analysis done by MMS essentially requires ranking by price the contracts to be included, and the corresponding volumes, with the highest price contract at the top. To find the highest price paid for a majority of the gas, MMS starts at the bottom (lowest price) contract and adds volumes until it

reaches the 51st percentile. The price paid under the corresponding contract is the highest price paid for a majority (or major portion) of the gas.10/

a. Field Versus Area

The first consideration is whether to use the field or area to identify the relevant contracts.11/ Neither NTL-5 nor the last sentence of 30 C.F.R. § 206.103 states explicitly when to use one or the other for the determination. On the one hand, it could be argued that since both rules refer to the highest price for the majority of production from the field or area, where MMS can do both computations (field and area), it must pick the highest of the two results. Alternatively, it could be argued that the rules are intended to give MMS flexibility since in some instances an areawide computation is not practicable (e.g., where there are private lands interspersed with Federal lands and MMS does not have access to sales and volume data). Finally, it could be argued that MMS has complete discretion to select either the field or the area. In any event, both 30 C.F.R. § 206.103 and NTL-5 certainly authorize MMS to consider contracts for the entire area.

MMS' existing practice for determining whether to use the field or area is to take three factors into consideration. First, MMS considers whether there is a common market for the products coming from the producing field. If the products from one or more fields in the same producing area are served by a single pipeline or gathering system and are marketed at a common terminal, then the area definition could be applied. Second, if there are unitization or communitization patterns in the area which extend over one or more fields producing from the same geologic formation, then the area definition could be applied. Third, if the products being produced from one or more fields are

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10/ Conservation Division Manual provisions designed to implement NTL-5 were prepared by USGS. MMS Royalty Management advises that the new CDM provisions were never finally promulgated by USGS. However, if they were, CDM § 647.2.3B includes a definition of "highest price paid for a majority of like quality production" which is essentially the same as that described above, except that the definition could be interpreted to suggest taking the weighted average of the top 50% to calculate the value. Alternatively, however, the term weighted average also could be construed as an inartful shorthand reference by USGS to the price attributable to the 50th to 51st percentile determined by a method as described above. The latter interpretation appears more reasonable.

11/ The Kenai Field is one of several fields in the Cook Inlet area. In this case, both the field and the area are distinctive and easily identifiable.

of the same general quality, e.g., gravity, sulfur content, etc., the fields could be considered a single producing area. These three factors are obviously not mutually exclusive. In most cases, MMS finds that at least two of the three factors exist.

MMS has applied these criteria to the Kenai Unit and determined that it is appropriate to compute the major portion based on contracts in the Cook Inlet area. We believe that MMS' decision is reasonable and defensible based on 30 C.F.R. § 206.103 and NTL-5.

b. Exclusion of Collier Volumes

The next consideration is whether any contracts for gas sales in the area and their corresponding volumes should be excluded from the computation. MMS proposes to exclude the non-arm's-length Collier volumes from the major portion analysis. This is appropriate. First, the last sentence of 30 C.F.R. § 206.103, refers to the "highest price per . . . thousand cubic feet . . . paid or offered at the time of production in a fair and open market . . ." (emphasis added). The Collier contracts, which are non-arm's-length inter-affiliate contracts which did not reflect market prices at their inception, hardly meet this standard.12/ Although NTL-5 does not contain similar language, NTL-5 is not inconsistent and was by its terms issued pursuant to the authority of § 206.103. Second, it is proper to exclude from the analysis prices which were set through non-arm's-length means because to do otherwise would allow lessees to manipulate the major portion analysis by setting artificially low prices. By way of illustration, since the Collier volumes are large, Union could reduce the royalty value for those volumes, as well as other volumes valued by the major portion method, by maintaining an artificially low price under the Collier contracts. Therefore, it is appropriate to exclude the Collier volumes, and any other similar non-arm's-length volumes, from the major portion analysis.

c. Exclusion of Rental Gas Volumes

MMS also proposes to exclude the rental gas contract volumes from the major portion analysis. We agree with this determination. The contract for the gas rental establishes a very low price per Mcf. It is evident that the price paid is consideration only for the rental value of the gas, not its sale, since the contract provides for return of up to 100% of the rented volumes. In view of the above discussion regarding the requirement to include in

12/ We do not suggest that there might not be instances where it would be appropriate to include volumes and prices from non-arm's-length contracts in such an analysis. The parties involved and the terms of the contract would require examination in each instance.

the major portion analysis only contracts which reflect prices paid in a "fair and open market", it is consistent to include only sales contracts and to exclude a rental contract. Even though the contract appears to be arm's-length, the price paid certainly is not a "market" price for the sale of gas, which is the value which MMS is attempting to ascertain. It therefore is appropriate to exclude the rental gas contract from the major portion analysis.

d. Application of the Value Determined By the Major Portion Analysis

Once the mechanics of the major portion analysis are established, the value determined thereby would be applicable to all gas volumes in the second classification, i.e. Collier volumes, rental gas volumes (discussed below), and APL-I and City of Kenai contract volumes from wells commenced after June 1, 1977. Pursuant to subsection II.C. of NTL-5, the values so established apply effective June 1, 1977.

The values computed using the major portion analysis likely will be higher than the values used by Union in paying royalties. Union may argue again that MMS cannot retroactively revise royalty values previously "accepted," but that argument should be rejected for the same reasons discussed above with respect to the arm's-length contracts. Moreover, Union has been on notice since the issuance of NTL-5, and particularly since the USGS expressly so advised Union regarding the Collier volumes, that royalty would be payable pursuant to the values prescribed by 30 C.F.R. § 206.103 and NTL-5.

2. Rental Gas Volumes

Despite the exclusion of rental gas volumes from the major portion analysis, the value derived from such an analysis is the royalty value for those volumes under NTL-5. Subsection VI of NTL-5 applies to "gas disposed of without sale and for which royalty or other compensation is due." Rental gas is disposed of without sale. Royalty is due on that production because 30 U.S.C. §§ 226(b) and (c) require payment of royalty on the "amount or value of the production removed or sold from the lease." (Emphasis added.) Consequently, royalty is payable when the rental gas is removed from the Kenai Unit and delivered to the user. Pursuant to NTL-5 subsection VI, the value "will be calculated in the same manner as the Supervisor calculates the value of other gas sold from the lease, communitized area, or unit participating area in accordance with the provisions of this Notice." Since Union's other Kenai Unit gas will be valued using the highest price paid for a major portion, it is appropriate to do likewise for the rental gas.

V. Conclusion

MMS is required to value Union's gas for royalty purposes as prescribed in 30 C.F.R. § 206.103 and PTL-5. MMS should prepare an order to Union in accordance with this memorandum.

Larry Jensen

Lawrence J. Jensen
Associate Solicitor,
Energy and Resources

bcc: DOCKET DER RF ROYALTY PF SCHAMBERG RF HEATH PF DANNEMEYER
RF:Schamberg:jp:343-4036:5/8/85:5/10/85:5/13/85

Exhibit VII

United States Department of the Interior

OFFICE OF THE SOLICITOR
WASHINGTON, D.C. 20240

JAN - 9 1987

PRIVILEGED ATTORNEY-CLIENT COMMUNICATION

PRIVILEGED ATTORNEY WORK PRODUCT

MMS.ER.0553

Memorandum

To: Assistant Secretary, Land and Minerals Management

From: Associate Solicitor, Energy and Resources

Subject: Retroactive Modification of NTL-5

This is in response to your request that we review the case law construing retroactive rulemaking to advise you regarding the legality of retroactively modifying Notice to Lessees and Operators of Federal and Indian Onshore Oil and Gas Leases (NTL-5) -- Value of Natural Gas for Royalty Purposes.

For the reasons explained in detail herein, we have concluded from our review that a retroactive modification to NTL-5 (to make retroactive the changes to NTL-5 adopted in the July 25, 1986 rulemaking, 51 F.R. 26759) is not per se illegal. The treatise writers have recognized that: "Like retroactive statutes retroactive rules are valid if they are reasonable, but are invalid if their retroactivity is unreasonable in the circumstances." K. Davis, Administrative Law Treatise § 7:23 (2d ed. 1979). However, it also has been acknowledged that retroactive agency action is subject to stricter scrutiny than prospective measures. Daughters of Miriam Center for the Aged v. Mathews, 590 F.2d 1250, 1259 (3rd Cir. 1978). The factual circumstances surrounding a retroactive rulemaking will be determinative of the potential legality of that action. Consequently, the administrative record developed during any retroactive rulemaking process is especially important. Our analysis follows.

The first section consists of an enumeration of the standards which courts have considered in determining the propriety of retroactive agency action, followed by application of those standards to the NTL-5 situation. Sections II through VI provide a more thorough analysis of the applicable case law.

I. Application of Retroactivity Considerations To a Modification of NTL-5

From our review of the case law, a court likely would apply the following criteria if presented with a challenge to a retroactive modification to NTL-5:

- While retroactive rules are not favored, they are not per se illegal; rather, the court will consider whether the action was reasonable in the circumstances. However, courts will apply stricter scrutiny to retroactive rules than to prospective rules.

- Does the retroactive amendment to NTL-5 make the rule consistent with the statutory scheme, thereby curing a deficiency in the original rule? If so, does the public interest in proper implementation of the statute outweigh the burdens placed by retroactive rulemaking on affected parties, considering the other factors listed below?

- What was the extent of the affected parties' reliance on the original NTL-5? The court will consider such factors as: the length of time the original provision was in effect; whether the modification is an abrupt departure from past practice or merely fills gaps in an unsettled area of law; and whether the lessees or the states and Indians would have altered their conduct had the modifications been in effect originally.

- The court will consider the hardship on the affected parties, i.e. whether the hardship to the lessees from no retroactivity is outweighed by the hardship to states and Indians if the modifications are retroactive.

- The court likely will apply the same analysis whether NTL-5 is considered to be a legislative rule or an interpretative rule. However, rules like NTL-5 which establish new requirements and do not merely offer an interpretation of an existing statute or regulation, generally are deemed to be legislative rules.

Applying the factual circumstances surrounding NTL-5 to the aforementioned principles results in some considerations favoring retroactivity and others working against it.

With regard to the underlying statutory purpose, MMS's position in support of retroactive rulemaking would be that applying the original NTL-5 to establish value in the 1984-86 period will result in some values which are so high as to be unreasonable and not in furtherance of legitimate statutory purposes (the relevant statutes do not provide any explicit guidance for determining value -- it is a matter committed to agency rulemaking authority). By way of illustration, there are circumstances where the "market" price of gas sold interstate uniformly is

several dollars below the NGPA ceiling price for the category of gas. NTL-5 conclusively would establish the royalty value at the ceiling price. If this value is so high as to be unreasonable, then MMS would argue that it would be furthering the statutory purposes by curing this defect in the regulatory scheme. For Indian leases, because of the Secretary's trust responsibility to the Indians, the court may conclude that the statutory purposes test places on the Secretary an even greater burden to demonstrate that an NGPA ceiling price is patently unreasonable (hence not justified by the statutes or leases) rather than just a "high" value.

We believe that recent case law makes an even stronger case for not changing NTL-5 retroactively for Indian leases. The Tenth Circuit Court of Appeals in Jicarilla Apache Tribe v. Supron Energy Corp., 782 F.2d 855, (en banc 1986), adopting the dissent reported at 728 F.2d 1555, held that the Secretary had a fiduciary duty to manage the tribe's natural resources to maximize benefits. Id. at 1565.

In terms of relative burden, modifications to NTL-5 work to the benefit of oil and gas lessees through lower royalties. Courts have upheld retroactive application of a rule which benefitted the regulated class. However, the modifications to NTL-5 will have a corresponding negative impact on the amount of royalty revenues received by the public, Indian lessors and the states. The courts necessarily will focus on this burden. Moreover, unlike most cases involving retroactive rules applicable to a regulated class, the balancing inquiry will not be limited to considering the impact on public or governmental interests, but will consider whether the burden on all royalty recipients is outweighed by the furtherance of the statutory scheme as it relates to leasing and payment of royalties on both Federal and Indian lands.

Operating in favor of retroactivity is the fact that the conduct by at least one party, the lessees, would not necessarily have been different had the NTL-5 modifications been in effect. On most leases where the NTL-5 value was significantly in excess of a lessee's gross proceeds, it is MMS's experience that lessees did not pay royalty at the NTL-5 prescribed rate. Rather, they paid royalties based on their proceeds. In some cases, this action was taken with the knowledge and concurrence of MMS. Therefore, a retroactive modification to NTL-5 in most instances would not take money out of the pockets of the Indians and states, but only would decrease their revenues from future audits of past activity. On the other hand, enforcement of the original NTL-5 would require the lessees to pay considerable sums of additional money after having been advised earlier by MMS that NTL-5 would not apply uniformly. It will be incumbent on MMS to develop the administrative record to demonstrate that lessees did not pay royalties at the NTL-5 rate, that many lessees acted based upon advice from MMS, and that Indians particularly would not be burdened by having to refund previously paid royalties if the rule is changed retroactively.

Two principal considerations will operate against retroactivity. Most importantly, as noted earlier, the statutory interests which will be considered by the courts will include the Secretary's trust responsibility to the Indians. The retroactive rule would be altering an established policy which benefitted the Indians, not just filling in a gap which existed in the applicable law. Thus, the benefit to the oil and gas lessees will be balanced against the detriment to the Indians. While there indeed may be situations where the NTL-5 value is unreasonable, the court may be concerned whether it is necessary to rescind NTL-5's applicability to all leases to cure the problem. Instead, it may be appropriate to develop standards and make the NTL-5 changes retroactive only in certain defined circumstances.

MMS's statutory purpose argument also will be undermined by the fact that in the 1984-86 period MMS was aware of the valuation problems caused by NTL-5 but took no corrective action. The court will not be as sympathetic as in a situation where an unforeseen change in circumstances requires a retroactive modification.

Also to be considered is the standard of review which will be applied to the MMS action. If MMS makes the recent modifications to NTL-5 retroactive, the likely lawsuit from the Indians and states will focus almost exclusively on the procedural issue of retroactivity. The burden will be on the agency to defend the reasonableness of its action in general. If, on the other hand, MMS continues to enforce NTL-5 as originally promulgated, the dispute will be with the lessees and will be a substantive challenge to an agency valuation order. The agency will have in its favor the principle of law that courts should defer to the agency's decision, particularly where the agency is interpreting its own statutes and regulations. See Marathon Oil Co. v. U.S., 604 F. Supp. 1375 (D. Ak. 1985), aff'd, 794 F.2d 1461 (9th Cir. 1986). The burden will be on the lessee to demonstrate that the agency's valuation was unreasonable and not in accordance with law.

In summary, whether a retroactive modification of NTL-5 is legally defensible will depend in large measure on the administrative record developed to support the agency's decision. What follows is a more thorough review of the case law which forms the basis for this conclusion.

II. Background

As is explained in more detail below, in ruling on the propriety of a retroactive rulemaking, courts have considered carefully the facts surrounding the rulemaking action, particularly focusing on who the affected parties are. As noted by Professor Davis, above, "reasonableness" of the retroactive rule is an important criterion. The NTL-5 situation is somewhat unique. The retroactive modification under consideration would benefit oil and gas lessees through lower royalties. Generally, when an agency takes action which benefits the class it regulates, even

if that action is retroactive, the agency action will not be challenged because no specific person or class is aggrieved. Here, however, the Indian lessors (who receive all of the royalties from production on their leases) and the states (who receive 50 percent of the royalties from federal leases pursuant to 30 U.S.C. § 191) would be directly and adversely affected by a retroactive change to NTL-5 which reduced royalty payments. Thus, a retroactive rule which benefits a private party and generally would not be subject to challenge in this case operates directly to the detriment of parties other than the U.S. Government. This dual impact must be considered when applying the principles gleaned from prior case law.

III. Early Cases

The courts recognized early that retroactive agency action could be warranted. In Addison v. Holly Hill Fruit Products, Inc., 322 U.S. 607 (1944), the Supreme Court sanctioned retroactive agency action. The agency had adopted a definition under the Fair Labor Standards Act which the Court concluded was beyond the agency's authority as conferred by statute. After striking down the agency definition, the Court remanded the matter to the district court with an instruction to hold the case until the agency adopted a new definition which would be applicable retroactively to the earlier period to which the original rule had applied.

One of the most frequently cited cases establishing the early principles for determining when retroactive rulemaking is appropriate is SEC v. Chenery Corp., 332 U.S. 194 (1947). While this case is more important for having established the principle that the choice between proceeding by general rule or by ad hoc adjudication is one that lies primarily in the informed discretion of the agency, the Court also ruled that just because an ad hoc decision of the Securities and Exchange Commission might have a retroactive effect does not necessarily render it invalid:

> Every case of first impression has a retroactive effect, whether the new principle is announced by a court or by an administrative agency. But such retroactivity must be balanced against the mischief of producing a result which is contrary to a statutory design or to legal and equitable principles. If that mischief is greater than the ill effect of the retroactive application of a new standard, it is not the type of retroactivity which is condemned by law.

Id. at 203. While this case dealt with an agency order rather than a rule, the above-quoted balancing principle has been applied by other courts to the rulemaking context.

As noted above, factual considerations surrounding a retroactive rule are an essential consideration. A later court striking down retroactive agency action noted that the rulings in Addison and Chenery may have been dictated by need since to permit the

industry to stand with no regulation (as opposed to applying the new rule retroactively) would have been contrary to the intent of Congress. National Labor Relations Board v. Guy F. Atkinson Co., 195 F.2d 141, 147-148 (9th Cir. 1952). (See also Niagara Mohawk Power v. FPC, 379 F.2d 153 (D.C. Cir. 1967), where the court upheld the retroactive effective date of a license (with the attendant higher fees) where the project otherwise would have been constructed without a license in violation of applicable law.)

The courts recognized early that when an agency adjudication is a case of first impression, it necessarily will have retroactive effect. Chenery, supra; NLRB v. Majestic Weaving Co., 355 F.2d 854 (2nd Cir. 1966). Stated another way, in a case where the agency is first announcing a rule as to how a person should have acted in a prior period, that ruling is retroactive in effect. This must be distinguished from situations, like with NTL-5, where an agency retroactively is altering an established rule which has been generally recognized and relied upon. In one case the court concluded:

> In this case we might well conclude that where for fifteen years the Board considered conditional negotiation consistent with the statutory design "the ill effect of the retroactive application of a new standard" so far outweighs any demonstrated need for immediate application to past conduct, SEC. v. Chenery Corp., supra, [citation omitted] as to render the action "arbitrary."

NLRB v. Majestic Weaving Co., supra at 860-861. Therefore, courts will be more considerate of retroactive rulemaking where an agency first is establishing a principle rather than amending a previously established policy.

Another case which established frequently cited standards for determining the validity of retroactive agency action is Retail, Wholesale and Department Store Union, AFL-CIO v. NLRB, 466 F.2d 380 (D.C. Cir. 1972). At issue was the Board's retroactive application of a change in policy effectuated by it through adjudication rather than rulemaking. Recognizing that courts sometimes will uphold retroactive rules, the court considered the following standards:

> Among the considerations that enter into a resolution of the problem are (1) whether the particular case is one of first impression, (2) whether the new rule represents an abrupt departure from well established practice or merely attempts to fill a void in an unsettled area of law, (3) the extent to which the party against whom the new rule is applied relied on the former rule, (4) the degree of the burden which a retroactive order imposes on a party, and (5) the statutory interest in applying a new rule despite the reliance of a party on the old standard.

Id. at 390. The court in this case refused to give retroactive effect to agency action.

IV. Recent Cases

In the more recent cases, courts have focused more closely on the severity of the harm to private interests caused by retroactivity, and have acknowledged "the doctrine that an administrative agency may not apply a new rule retroactively when to do so would unduly intrude upon reasonable reliance interests." Heckler v. Community Health Services of Crawford County, Inc., 467 U.S. 51, 60 at n.12 (1984). The courts' inquiries have been even more factually oriented than in the early cases. This analysis has resulted in retroactive regulations being both sustained and overturned.

The effect of the factually-oriented inquiry is evidenced by a series of cases decided by the Temporary Emergency Court of Appeals (TECA) both upholding and striking down retroactive rulemaking actions by the Department of Energy (DOE, including predecessor agencies). In Standard Oil Co. v. DOE, 596 F.2d 1029 (TECA 1978), DOE sought to apply retroactively a petroleum price control regulation which would have imposed a significant burden on crude oil refiners. The court, which considered the principles adopted in Chenery, supra, and Retail, Wholesale, supra, reasoned as follows:

> Had the NPCI last rule been in effect during the relevant period, the refiners would admittedly have followed different procedures with respect to reduction of inventories, cutting back domestic refinery output, and avoiding constant price changes.

Id. at 1065. Thus, TECA examined whether the conduct of the affected class would have been different had the new rule been in place from the beginning. The court concluded that the rule should not be given retroactive effect.

TECA came to the opposite conclusion in two other cases. In Pennzoil Co. v. DOE, 680 F.2d 156 (TECA 1982), which involved a DOE ruling regarding its crude oil pricing regulations, the court again reviewed the balancing principles from the early cases including Chenery and Retail, Wholesale. It also cited Professor Davis (same quote as in the opening section of this memorandum) in concluding both that the regulation in dispute was reasonable and that it could be given retroactive effect. However, it should be noted that the court also stated that:

> the controlling circumstances here is [sic] that Ruling 1975-15 is an interpretative ruling, not a legislative change, and simply made explicit what was implicit in the property definition from the beginning.

Id. at 176. Thus, the rule which was upheld was not a legislative rule. Rather, the court upheld it as an interpretative rule which from the beginning was consistent with the underlying substantive rule. Consequently, its effect was not really retroactive.

The third TECA case, which involved retroactive repromulgation of a crude oil pricing rule that a court previously held to be invalid, includes an extensive legal analysis of the retroactivity issue. Mobil Oil Corp. v. DOE, 678 F.2d 1083 (TECA 1982). The court recognized that "administrative agencies have the authority, under limited circumstances, to issue retroactive rules." Id. at 1088. However, the court concluded that:

> Since the DOE has not shown that there will be a significant "mischief of producing a result contrary to statutory design . . .," Standard Oil, 596 F.2d at 1063, and since the absence of the 1974 amendment or a similar amendment does not necessarily "do violence to the law . . .", we conclude that the retroactive repromulgation of the 1979 amendment is invalid.

Id.

In most of the other recent cases, the courts have rejected retroactive rulemaking. Where retroactive effect has been approved, there appears to be a mitigating circumstance which justifies such action.

In Daughters of Miriam Center for the Aged v. Mathews, 590 F.2d 1250 (3rd Cir. 1978), HEW changed its rules on depreciation recapture after the appellant chose its depreciation method based upon the prior rules. The new rule would have created a financial hardship for appellant. The court first stated that in reviewing retroactive measures, courts have applied stricter scrutiny than with prospective measures. It reasoned further that while the validity of a prospective rule will be sustained so long as it is reasonably related to the purposes of the enabling legislation (citing Mourning v. Family Publication Service, 411 U.S. 356, 369 (1973)), "'courts have generally compared the public interest in the retroactive rule with the private interests that are overturned by it' in deciding whether to uphold a retroactive promulgation." Daughters, supra at 1260, quoting from Adams Nursing Home of Williamstown, Inc. v. Mathews, 548 F.2d 1077, 1080 (1st Cir. 1977).

The court further articulated another standard:

> In a retroactivity challenge such as the present one, a critical question is how the challenger's conduct, or the conduct of others in the class, would have differed if the rule in issue had applied the from start.

Daughters, supra at 1262. This is similar to the analysis applied by TECA in Standard Oil, supra. As a consequence of its analysis the court concluded that:

> This severe impact upon the Center's finances, overturning its settled expectations, outweighs the negligible public interest in applying the new provision retroactively to it.

Id. at 1263. See also Bedford County Memorial Hospital v. HHS, 769 F.2d 1017, 1024 (4th Cir. 1985) (Court overturned retroactive rule concluding that "While retroactive rulemaking designed to cure defects in regulatory schemes sometimes should be permitted, this should only occur when the public interest in retroactively curing the defect outweighs the harm to private interests resulting from invalid first instance rulemaking").

Applying similar principles, some recent decisions also have upheld retroactive rulemaking. In People of the State of California v. Simon, 504 F.2d 430 (TECA 1974), where appellant challenged the Federal Energy Office's rescission of the state and local government exemption of crude oil from federal price controls, the court upheld a rule with retroactive effect. However, the case is somewhat unique in that the rule was made retroactive only to the date of the notice of proposed rulemaking (NOPR), and the NOPR included express notice that the rule would be made retroactive to that date when adopted.

Retroactive rulemaking also was upheld in United States v. Exxon Corporation, 561 F. Supp. 816 (D.D.C. 1983), another case construing DOE crude oil pricing regulations. The court reviewed the principles enumerated by Professor Davis, quoted above, and by the court in Pennzoil Co. v. DOE, supra, and applied a balancing test. The court approved the retroactive rule because it actually relieved the burden on the affected party.

One of the most recent cases upholding retroactive application of an agency interpretation is based upon an analysis similar to that which a court would apply in reviewing a retroactive modification to NTL-5. In State of Illinois by the Illinois Department of Public Aid v. Bowen, 786 F.2d 288 (7th Cir. 1986), the State of Illinois brought an action against HHS claiming about $4 million in federal reimbursement for Medicaid medical services provided by the state. The basis of the claim was that HHS originally interpreted one of its regulations as providing a limited exemption from a statutory provision which generally denied reimbursements for the services in question. However, HHS reversed its interpretation and then denied the claims. The court reviewed most of the principles regarding retroactive application which are discussed above. It applied those principles as follows in upholding the retroactive interpretation:

> In this case any reliance interest of the [State] is outweighed by the Secretary's interest in retroactively applying its current interpretation of the regulation. A critical question is how the conduct or practices of the [State] would have been different if the current interpretation of the regulation had applied from the start. See Daughters, 590 F.2d at 1262. The district court found that Illinois would have provided the services in question regardless whether it received [federal reimbursement]. Such services are traditionally the responsibility of the states . . . . Further, this is not a case in which HHS is demanding a refund from the [State] or assessing a fine.

Id. at 292-293. The court considered also that the statutory terms seemed clear, that no other state received any funds based on the original interpretation, and that it is unlikely that the state relied heavily on the original interpretation creating a loophole in the statute.

V. Other Retroactive Royalty Cases

The question of whether a Department of the Interior royalty order could be applied retroactively was considered before in the landmark case of Continental Oil Co. v. U.S., 184 F.2d. 802 (9th Cir. 1950). The principal issue in the case was whether the Secretary's royalty valuation rules were proper. With regard to retroactivity of the so-called net realization order, the court rather summarily rejected retroactive application, stating that "we think the court correctly construed the provision of the lease permitting the Secretary to fix the value of gas for royalty purposes as operating prospectively only." Id. at 821. It should be noted that the Secretary's order in this case had the effect of increasing royalties.

VI. Legislative Rules v. Interpretative Rules

It was suggested in several comments from industry that MMS could retroactively modify NTL-5, or, alternatively, that the MMS could choose not to apply NTL-5 in all circumstances, because it is only an interpretative rule as opposed to a legislative (or substantive) rule. We previously considered this issue in a May 16, 1985 memorandum to the Director, MMS, and determined that NTL-5 is a substantive rule with the force of law, and the agency is bound to enforce its terms. United States v. Nixon, 418 U.S. 683 (1974). We have revisited the issue and for the following reasons we have come to the same conclusion.

The distinction between legislative rules and interpretative rules is not easy to make with courts often differing in opinion when addressing the same fact situation. See K. Davis, Administrative Law and Government, 119 (2d ed. 1975). See also B. Schwartz, Administrative Law, 158, 159 (2d ed. 1984), which states:

> A substantive rule or "legislative-type rule" is one "affecting individual rights and obligations"; . . . they create law just as the statute itself does, by changing existing rights and obligations. An interpretive rule is a clarification or explanation of existing laws or regulations, rather than a substantive modification of them. Interpretive rules are statements as to what the agency thinks a statute or regulation means; they are statements issued to advise the public of the agency's construction of the law it administers.

Professor Davis also has focused on the distinction between the two types of rules:

> One very solid proposition is this: Whenever a legislative body has delegated power to an agency to make rules having force of law (whether or not the delegation is explicit) the rules the agency makes pursuant to the granted power have the same force as a statute if they are valid, and they are valid if they are constitutional, within the granted power, and issued pursuant to proper procedure; a court may no more substitute its judgment as to the content of a legislative rule than it may substitute its judgment as to the content of a statute. . ..
>
> At the opposite extreme, where no power has been delegated to the agency to make law through rules, the agency's public statements of what it will do in enforcing or in adjudicating may be deemed "interpretative rules." The solid proposition here that is fully supported by the case law is: Courts are free to substitute judgment as to the content of interpretative rules, but they often give weight or great weight to the views of the agency, sometimes even to the extent of giving force of law to the rules. . ..

Davis, supra at 119. With regard to royalties, Congress has given the Secretary broad power to make rules having the force of law. See 30 U.S.C. § 189. Likewise, the Secretary has broad authority under the various Indian mineral leasing statutes to establish regulations governing valuation. 25 U.S.C. §§ 396, 396d. The issue is whether NTL-5 is an effectuation of that authority creating enforceable obligations, or whether NTL-5 simply interprets other royalty value regulations.

An examination of how the courts have treated the distinction between legislative and interpretive rules is helpful in deciding the question as to what type of regulation NTL-5 is.

In General Motors v. Ruckelshaus, 724 F.2d 979 (D.C. Cir. 1983), the Environmental Protection Agency (EPA) issued what it characterized as an interpretative rule requiring any auto maker to submit a plan to remedy defects in an automobile regardless of

the age or mileage. The court concluded that this was an interpretative rule, stating that the difference between an interpretative and legislative rule is a product principally of the agency's authority and intent in promulgating the rule.

In Citizens to Save Spencer County v. United States Environmental Protection Agency, 600 F.2d 844 (D.C. Cir. 1979), the EPA promulgated three rules. In its brief to the court the EPA argued that each rule was interpretative. The court agreed with the agency on the first rule which amended EPA regulations to comply with one of two conflicting sections of 1977 amendments to the Clean Air Act. The second and third rules, however, sought to fill a breach in a timing issue opened by inconsistent instructions from Congress. The court concluded that the first rule was interpretative because the EPA decided merely to follow one of the conflicting statutory instructions. On the other hand, because the second and third rules sought to fill a breach in timing, the EPA had created new law, and therefore those regulations were deemed to be legislative.

See also American Trucking Association v. United States, 688 F.2d 1337 (11th Cir. 1982), rev'd on other grounds, 467 U.S. 354 (1984); Chamber of Commerce of the United States v. Occupational Safety and Health Administration, 636 F.2d 464 (D.C. Cir. 1980).

The facts surrounding NTL-5's promulgation do not completely clarify the issue as to whether NTL-5 is legislative or interpretative. The fact that NTL-5 was issued in the "Notices" section of the Federal Register, 42 FR 22610 (May 4, 1977), and that it states only that it is issued pursuant to the authority of 30 CFR 221 (the predecessor to 30 CFR Part 206), might indicate that NTL-5 is only an interpretation of the basic gas valuation rule in 30 CFR § 206.103 (although the Office of the Federal Register did write the MMS in 1982 stating that NTL's are rules and should be classified as such).

However, more factors indicate that NTL-5 is a legislative rule. NTL-5 was promulgated in proposed form for comment (40 F.R. 54267 (Nov. 21, 1975)) before it was issued in final form. These are the procedures which the Administrative Procedure Act, 5 U.S.C. § 553, prescribes for most legislative rules (though agencies of course are free to add procedural safeguards even for interpretative rules). Also, in the NOPR for NTL-5, supra, the agency stated that "Notice is hereby given that the Geological Survey proposes to revise, effective July 1, 1976, its method of determining value for royalty purposes on gas produced from, or for the benefit of, onshore Federal and Indian oil and gas leases." (emphasis added). Therefore, it would appear that the agencies intent at the time was to "revise" the existing gas valuation procedures, which would require a legislative rule since the rules to be amended were in the C.F.R. Also, NTL-5 as finally issued includes many requirements not in 30 C.F.R. Part 206 and MMS expects lessees to comply with the requirements. This too suggests that NTL-5 is a legislative rule.

The history of NTL-5's issuance, coupled with MMS's reliance on NTL-5 as the exclusive onshore and Indian gas valuation methodology (also, recall that that was the agency's announced position in the Alaska royalty dispute with Union Oil Co.), causes us to conclude that NTL-5 is a legislative rule.

It should be noted, however, that in several of the cases concerning retroactivity discussed above, the courts applied the same analysis to the propriety of retroactive changes to interpretative rules as they did to legislative rules. See State of Illinois by the Illinois Department of Public Aid v. Bowen, supra; Daughters of Miriam Center for the Aged v. Mathews, supra; U.S. v. Exxon Corp., supra at 836 ("The fundamental criterion for determining whether a statute, regulation or interpretation may be applied retroactively is one of reasonableness." (emphasis added)); Anderson, Clayton & Co. v. U.S., 562 F.2d 972, 984 ("Neither the courts nor Congress have drawn any distinction between interpretative and legislative Treasury Regulations as regards their retroactivity.") Consequently, even if NTL-5 is considered to be an interpretative rule, the same retroactivity analysis would be necessary to determine its legality.

VII. Conclusion

For the foregoing reasons, we believe that a retroactive modification of NTL-5 may be legally defensible. However, before we can provide you with a final opinion, an administrative record that supports the agency's decision must be developed along the lines discussed above.

Constance B. Harriman

Constance B. Harriman

Exhibit VIII

Royalty Amounts Paid Pending Appeal of NTL-5 Related Issues For Appeals on Hold within the Minerals Management Service

Docket No.	Appellant	State/Tribe	Amount
85-0030-O&G	Apache Corporation	Texas	$ 3,258
85-0125-IND	ANR Production	Cheyenne Arapaho	555
85-0147-O&G	Alta Energy Corp.	Colorado	1,002
85-0159-IND	Roy Lawrence Drilling Co., and Phillips Petroleum	Pawnee	11,421
85-0168-O&G	Chevron U.S.A.	Wyoming	4,417
85-0189-O&G	Petroleum Development Corp.	New Mexico	14,547
85-0234-O&G 85-0328-O&G	Natural Gas Corp. of California and FMC Corp.	Wyoming	69,031
85-0256-IND	Mesa Petroleum	Cheyenne Arapaho	1,885
85-0337-O&G	Teton Energy Co.	Colorado	55,062
86-0043-O&G	Northwest Exploration Co.	Colorado	118,245
86-0133-IND	Tri-Centrol	Chippewa-Cree	8,187
86-0489-IND	Tri-Centrol	Chippewa-Cree	41,832
86-0495-IND	Midcon Central	Kiowa, Cheyenne Arapaho, Caddo	18,776
87-0047-O&G	Belco Petroleum	Utah	147,766
87-0072-O&G	Chevron U.S.A.	Utah	3,534
Total			$499,518

STATE OF WYOMING
OFFICE OF THE GOVERNOR
CHEYENNE 82002

MIKE SULLIVAN
GOVERNOR

NTL-5 POSITION

July 6, 1987

BACKGROUND:

1. Notice to Lessees and Operators of Federal and Indian Onshore Oil and Gas Leases No. 5 (NTL-5) was issued on June 1, 1977, and generally required that gas be valued at the regulated price approved by the Federal Power Commission. This was subsequently interpreted to mean the Natural Gas Policy Act (NGPA) ceiling price. These ceiling prices were generally comparable to contract prices at that time.

2. Beginning in 1982, gas prices started to decline and continued on their downward slide through 1986 (while NGPA ceiling prices which are inflation adjusted, continued to increase). Through market out clauses or contract renegotiations with pipeline companies, most Federal and Indian lessees received less than NGPA ceiling prices.

3. In 1984 or earlier, the Department of Interior communicated with many lessees indicating their intent to not enforce NTL-5, and to enforce 30 CFR 206.103 for valuation purposes. In general, standard industry practices resulted in royalty payments being made on the basis of gross proceeds received by lessees rather than ceiling prices under NTL-5.

4. Significant questions have surfaced regarding the legality and equity of applying NTL-5 across-the-board to all lessees during the period from May, 1982, when the first market-outs occurred, through August, 1, 1986, when the Department modified NTL-5 prospectively to allow valuation based upon 30 CFR 206.

POSITION:

1. From May, 1982 through August 1, 1986, NTL-5 may not reflect "reasonable value for the product" for royalty purposes as required by law. Relief from the restrictive provisions of NTL-5 should be granted by the Department only on a case-by-case basis through determining reasonable value based upon arms-length contracts, and, at the earliest, following legitimate market-outs or other events which forced a lessee to take a price less than the ceiling price. This appears to require a modification to NTL-5, made applicable retroactively.

2. In determining a reasonable value on a case-by-case basis, protections should be in place to avoid determining value based on verbal agreements, retroactive contracts, non-arms-length contracts, or other considerations apart from legitimate market conditions which may have influenced the lessee's decision to accept less than fair value for the gas. The lessee should have the burden of documenting events or conditions which warrant a departure from NTL-5 in determining value. Gross proceeds should remain the minimum value for royalty purposes. Representatives of the Department of Interior, States and Congress should work together cooperatively to arrive at language which addresses the inequities underlying the NTL-5 issue.

3. States should not bear the financial burden for misguidance or untimely decisions by the Department. Any refunds due companies should be credited against the Federal share of future royalties.

4. The Department should immediately notify lessees to retain all records during this period for audit purposes.

5. The Department and State Auditors should aggressively pursue audits of companies to assure that all royalties due State and Federal governments have been paid.

Colorado

North Dakota

Montana

Utah

New Mexico

Wyoming

Senator MELCHER. Mr. Bettenberg, are you under the impression if you have satisfied the Senate Appropriations Committee, your problems are over?

Mr. BETTENBERG. No, sir.

Senator MELCHER. I would appreciate if you would look to this committee, the Senate Energy and Natural Resources Committee and this subcommittee as being participants in getting this resolved. There is quite a few of us on this committee, even though our esteemed Chairman and ranking member and Senator Nickles and maybe one or two others, happen to serve on the Senate Appropriations Committee, we really look to this authorizing committee as having the primary responsibility.

Senator NICKLES. If the Chair would yield, I would like to echo your comments. I know in wrestling with this issue in the Appropriations Committee, basically no one knew what we were talking about when we were discussing NTL–5, whether that be on the Senate side and/or on the House side and certainly in the conference.

And so, I would totally agree with your comments and I appreciate again your having this hearing. I guess you know we have a vote and we will need to leave.

Senator MELCHER. Reality.

Senator NICKLES. Reality strikes again.

Mr. BETTENBERG. Mr. Chairman, I couldn't agree with you more. As a former budget director for the Interior Department and seeing all the things that happen in the appropriation process with a fair amount of dismay, I would hope that you would in fact tackle this particular issue.

There will be, if we settle this on the basis that the States have proposed, a requirement for some language that effectively is an appropriation. That might be the proper place to handle this because it would be an appropriation from the funds that would otherwise be deposited in the General Fund of the Treasury.

Senator NICKLES. That would require legislation to enact that?

Mr. BETTENBERG. To do that part it would. We are basically faced with two choices at this point. After November we could implement our proposed revision of the regulations. If we implement that, that doesn't solve the $500,000 recoupment question that the States and tribes are concerned about—or at least some tribes. There may be some tribes who are opposed to us doing this at all. I think you may have some testimony from them today.

The second alternative is for Congress to legislate the issue. My personal preference is for it to be legislated because it will otherwise be litigated. And we might not have a resolution through the courts for several years. So, I think that if it were legislated, it would remove a cloud from the program. We would be able to proceed with audits, which is important. Our audit program is alive, very healthy. We have collected some $360 million over the last few years from it, and I would like our auditors to be able to get on with that work.

Senator MELCHER. I want to be sure we understand this correctly. You think within a matter of weeks that the Department of the Interior, MMS, will have reached a point of proposed settlement

with both the States and the tribes, and then you would move forward with the regulations however modified.

Mr. BETTENBERG. That is not correct.

Senator MELCHER. That is not correct.

Mr. BETTENBERG. I think within a matter of a week we will have reached agreement with the States.

Senator MELCHER. But not with the tribes?

Mr. BETTENBERG. But not with the tribes.

We will meet with the tribes next Thursday. We have not previously had conversations with them about a settlement on the basis that we are talking about with the States. That has been developed just over the last week and a half. Representatives from this committee staff, in fact, participated in a meeting that we had a week ago Thursday on that subject with representatives of the governors.

I have confidence that we will resolve the issue with the States, but in order to resolve it with the States, it would require that we not recoup roughly $200,000. That would take some legislation because we are otherwise required by law to recoup this money.

With regard to the tribes, I am not sure that we will be able to reach agreement because there are many tribes that do not want us to do this retroactive rulemaking, that believe that you should charge royalties on prices that people do not receive even when it is in arm's length contracts. In fact, there is some law that supports them on that, the *Supron* decision in New Mexico.

Senator MELCHER. Which decision?

Mr. BETTENBERG. The *Supron,* S-u-p-r-o-n, provides that we have to look at whatever reasonable methods of valuation there may be and choose the highest on behalf of an individual tribe or group of allottees.

Senator NICKLES. There are other court cases too that go back to market price as well.

How much money are you talking about as far as——altogether, the states and the tribes?

Mr. BETTENBERG. Well, the States and tribes, if we were to enforce the FERC ceilings, would run roughly $133 million to $134 million, to the best of our ability to estimate. Of that we have actually issued demand letters on about $5 million of it and collected about $500,000 of it. The rest of it is bonded,

Senator NICKLES. Mr. Chairman, we need to vote. We need to come back to this issue as well.

Senator MELCHER. Might I ask if we need Mr. Bettenberg more?

Senator NICKLES. I would like to pursue it a little bit further.

Senator MELCHER. All right.

Mr. BETTENBERG. Mr. Chairman, we will stand by.

Senator MELCHER. The subcommittee will stand in recess until Senator Wirth or one of the rest of us get back here. And we will just proceed as best we can.

[Recess.]

Senator WIRTH [presiding]. In the interest of time, perhaps we could come back to order and take up several questions that the committee wants asked on the record.

Mr. Bettenberg, first of all, it is my understanding that you promulgated or drafted a regulation at the end of July 1986 that

would provide for prospective action, and then changed that in January to provide for retroactive action. Is that right?

Mr. BETTENBERG. That's correct. We promulgated one that covered the prospective period in July of last year, as I indicated in my opening statement, and after further review concluded that we really had to go back in and fix the mistake that had been made.

Senator WIRTH. What happened in that 5-month period of time?

Mr. BETTENBERG. I think we got a much better handle on the unreasonableness of the application of NTL–5 to the actual market during that period.

Senator WIRTH. Did some dramatic, new piece of evidence come in, or——

Mr. BETTENBERG. Nothing dramatic.

Senator WIRTH. This would appear to be a pretty significant shift in policy.

Mr. BETTENBERG. I testified in another hearing that is not an easy issue for us because we don't like to make retroactive rulemaking. We like our rules to be firm, fair, fixed and applicable for all time until changed and then prospectively.

We have frankly confronted this issue twice and have come down on both sides of it, which is not a great performance. The conclusion that we reached last year was that we should go prospective, and we did that primarily out of concern for the retroactive issue. As the evidence began to mount on what the amount of the disparity was and the fact that virtually no one had ever paid on the FERC ceiling prices when they were at variance with gross proceeds, we concluded that we really needed to go back in and correct that. That's the reason why we proposed a new rule and sought comment in January.

Senator WIRTH. One aspect of the process that concerns me is I would, as I stated in my opening remarks, prefer that you do this through regulatory action. And you stated, as I understand, in your opening remarks that one of the problems was that we would face—if you were to go ahead with the January regulation, you thought you would face legal action.

Mr. BETTENBERG. Yes. Whether we go ahead with it or not, we will face legal action.

Senator WIRTH. And having been on one side and then on the other side of this issue, you haven't strengthened your position very much in terms of being able to defend yourself against potential legal action. So, you have really almost made it imperative that we step into this.

Mr. BETTENBERG. Well, I would have some of my words thrown back at me in court I'm sure.

Senator WIRTH. Yes.

Mr. BETTENBERG. I have made comments in other fora regarding retroactivity. On the other hand, we think that the evidence is in fact overwhelming, as we continue to accumulate it, that collecting royalties on FERC ceilings is so at variance with the underlying statute that I think that we are confident that we would prevail on it.

Senator WIRTH. Let me ask you another question. How much money is involved?

Mr. BETTENBERG. If we were to apply the FERC ceilings without variation, our estimate is that it would be about $133 million to $134 million. That's a maximum figure. It may well be that in some of those cases, we would look at them and conclude that the amounts actually paid were underpaid even without regard to the FERC ceiling. So, when I say $133 million to $134 million, that is probably a maximum.

When we have arm's length contracts, normally we will accept the value under that arm's length contract. But when we don't have arm's length contracts, as is often the case, then we are extremely suspicious of the values that companies set for intercompany transfers. A company will have a producing arm selling to a pipeline arm, and purely for royalty purposes. You can end up with situations where they will undervalue the gas at the wellhead and take their profit in the pipeline. That is the reason why we have an audit force of roughly 200 people—or one of the reasons is to be able to go back in and examine those kinds of situations.

Senator WIRTH. How many appeals are pending now on these royalty valuations?

Mr. BETTENBERG. We have several hundred appeals that are pending at any one time. We probably decide about 60 a month. On the NTL–5 issue, my recollection is that it is just a little over 40. It would certainly be more than that except for the fact that we have suspended issuing more bills until we resolve the underlying rule.

Senator WIRTH. And would congressional action help you sort out the appeals and expedite the process?

Mr. BETTENBERG. What would happen if we had congressional action on it is that I would remand those 40 some cases back to Mr. Moyers and his staff to review them under our underlying regulations and the Code of Federal Regulations on valuation. That would be done on a case-by-case basis. Initially that would resolve the NTL–5 aspect of those appeals.

Senator WIRTH. In the ideal world, from the position in which you sit, Mr. Bettenberg, what procedures would you like to see followed, what in terms of legislation would expedite this to get this problem sorted out and behind us? What would happen tomorrow? What would happen in August, September, October, past the November 1 date and so on? What do we have to do in your opinion to get this sorted out as quickly as possible?

Mr. BETTENBERG. At a minimum we need to be allowed to go ahead with the rulemaking. That is a minimum and probably isn't the most favorable outcome at this point to get the whole issue behind us quickly.

I think that some legislation is what is needed, some legislation that would provide that we would use our underlying Code of Federal Regulation rules for purposes of valuation and would set aside this sort of a situation as depicted on the chart for that 1982 through 1986 period.

We have some draft language that we will be talking to the states about next Wednesday, and I am confident that we are going to be able to reach an accommodation with them at that time. And I would then like to see Congress move that quickly.

In terms of legislative vehicles, I am frankly neutral on vehicles. The Senate Appropriations Committee, which initially brought us

into this situation on the supplemental measure, is marking up on the 1988 bill, we understand, the week of the 20th. It would be my desire to have it in some form or another before Congress so that they could act on it—before the Senate so they could act on it—something that could use that vehicle. But if there is a faster vehicle—since that will have to go through a conference, and you wouldn't expect it to be resolved until September—I would think that we would certainly be amenable to that as well.

I would be delighted to see this committee exercise jurisdiction on it and resolve it.

Senator WIRTH. As a final question, are there significant differences between Indian and Federal leases that might require different rules?

Of the $132 million, how much is related to the Indians?

Mr. BETTENBERG. We estimate that about $8½ million is related to Indians. I think that there may be——

Senator WIRTH. That's $8½ million out of $132 million——

Mr. BETTENBERG. Right.

Senator WIRTH [continuing]. Would relate to Indian lands. Is that right?

Mr. BETTENBERG. Would relate to Indian lands.

We estimate, based on the cases before us, that we have actually collected about $85,000 of that. We have some larger amount that is on appeal but bonded.

There may be some disagreement on that amount. My understanding is that the Southern Utes have made an estimate that might be perhaps in the range of $7 million or so. And we have people who are going through that right now to see whether that holds up or not. I hope that we will have gotten through that process some time next week as well. But that's our estimate.

Indian leases frequently will have different wording than Federal leases which will allow the possibility of using several different methods of valuation. When that is the case, our guidance is to use the highest reasonable method that you can use as part of our trust responsibility.

Even that aspect of it is still being litigated. For instance, in the Wind River case, as I understand it, the tribe is maintaining that the highest reasonable price is the average of the highest prices in the field, not the average of all the prices in the field. And so, that is one that is still in the courts.

There are those sorts of variations. In most cases probably you come up with the same outcome. And in fact, for one specific lease or set of leases that I recall we used three different methods and came up with essentially the same answer with each method.

Senator WIRTH. Thank you, Mr. Chairman.

Senator MELCHER. Senator Nickles.

Senator NICKLES. If I might follow up on Senator Wirth's comments, I think there is some confusion over liability or potential liability. How many dollars are actually subject to refunding in your estimation?

Mr. BETTENBERG. The amount that we think we have collected from industry and would need to refund based on the best accounting that we have done so far is just a few dollars under $500,000. It is $499,500 and some. Presumably all or part of that could be re-

funded based upon a further audit review if the intrastate gas part of NTL–5 were set aside for this period.

Senator NICKLES. And out of that $500,000 how much would be for the tribes?

Mr. BETTENBERG. About $85,000 of it would have been for either tribes or allottees, and we would either have to recoup that under the current law under which we operate or else have to have an amendment that would cover that.

Senator NICKLES. I want to make sure that Senator Wirth and I are on the same wavelength because we worked on this problem together.

In other words, you have actually paid or have received royalty payments on amounts in excess of market of about $500,000 or the Indian tribes have. But the potential liability, if you did not make a retroactive rule, subject to litigation would be the $130 million sum.

Mr. BETTENBERG. That's the potential liability as we see it. That I think we think is a maximum number.

Senator NICKLES. Well, I appreciate it. I have heard that $130 million since we have been working on this. What we are trying to do is to, as Senator Melcher has said, provide that royalties should be paid on market price. And if royalties are paid on market price, then that $130 million royalty is not there.

Those few cases where they did pay royalties in excess of market price may be because the producer happened to be a very small producer and maybe wasn't aware of the fact that everybody else was paying it strictly on market price or he didn't appeal it or whatever—I don't know. Maybe he didn't get a letter from MMS. But anyway, you're not talking about very much. You're only talking about $500,000. But the potential liability is $130 million, and that $130 million is all in excess of what the market price is. Is that correct?

Mr. BETTENBERG. That should be correct, yes.

Senator NICKLES. Well, I would implore you to move, as we basically are I hope telling you to do, as soon as the postponement that was enacted in the supplemental expires—in other words, the beginning of next fiscal year—to implement the rule retroactively so you don't have $130 million worth of litigation.

If you don't do that—correct me if I'm wrong—you are subjecting all these producers, many of which are in very bad financial straits, to litigation so they would have to pay royalties on prices far in excess of what they received. It would be tied up in courts for years, not to mention the court costs and so on. It is just absurd.

So, I just urge you to move forward as rapidly as possible. I am not going to lose sleep over the $500,000 or even $85,000. Hopefully, maybe those things can be worked out. Take care of whatever state problems or Indian problems we can. If you can do that from royalties that MMS receives in some way or another, fine. I would like to do that. I would like to make it as tight as possible.

But I am concerned about a fix that would have us try to legislate a solution that might be very difficult, particularly when you possibly have a lot of people in some areas that say they don't want to do anything retroactively. So, then sorry, people, but you're sub-

jected to all this litigation. You have been saying for years you are going to correct the problem. I would encourage you to correct it as promptly as possible and avoid this enormous maze of litigation that will happen unless you make the ruling effective.

Mr. BETTENBERG. Senator, we will be litigated on either side of the issue if left to our own devices. You know, we cannot proceed right now because Congress has stopped us from proceeding, as you are well aware. However, we can proceed in November. If we proceed in November, I would predict that we will be litigated if not by the States, at least by tribes. And that is the reason why I have indicated that we would see a legislative solution as perhaps being more favorable because that would get the issue behind us and would stop the litigation.

Senator NICKLES. Let me make a couple comments.

Mr. BETTENBERG. We are proceeding either way though.

Senator NICKLES. I would encourage you to proceed because, one, I don't know the legislation will make this wave go away, and legislation is a lot easier said than done and it possibly can be not constructive legislation.

Also, you mentioned that it would be litigated either way. That may be, but I would find it very hard for people to litigate saying, well, we should be receiving royalties on prices substantially in excess of the market. I don't know that that case is very strong. I don't believe it is very strong. But if you reverse it the other way around, I think you are asking for litigation. And you are going to prompt a great deal more litigation unless you make this ruling.

And so, again, I make my plug for trying to avoid the legislative solution. You only have $500,000 that has been paid in excess of what market price is, but you would be subjecting—if you don't make the ruling, it looks to me you are going to be looking at litigation dealing with about $130 million. There are significant differences between the two. And if we can solve the $500,000 problem, I am more than willing to do that. But I would really hate to see us expose an industry that is already hurting and in bad shape. And again, most of these people that would be really suffering with it aren't so much just your majors, but the entire industry.

So, I appreciate your comment, and I also appreciate your waiting for us to return.

Senator MELCHER [presiding]. Mr. Bettenberg, how accurate are those estimates?

Mr. BETTENBERG. The $133 million or $134 million estimate is a gross estimate made looking at average market prices and NTL—FERC ceiling prices, and so it clearly has some swing in it. The $400,000 and some—$500,000, actually collected—is our best refinement of the cases at this point.

When we met last week with members of your staff, we had a higher number than that, but as we looked at one particular case that involved about $1.6 million, we discovered that the part that covered the retroactive period on that particular appeal had been bonded, and the actual collection was for an earlier period. So, we have continued to refine it.

The number in the testimony is as accurate as we can make it right now. We think that it is pretty darn accurate. There may

have been some small amounts that were paid without appeal, but we don't have any number on that at this point.

Senator MELCHER. Now, on the amount that has gone to the tribes, how much have gone to allottees? In other words, you have figures for both: how much has gone to the tribes and how much has gone to allottees, I assume. I don't know that we can break it down from your testimony.

Mr. BETTENBERG. I can't give you that number. All of the numbers that I have are Oklahoma leases. Those total about $85,000. It includes four different tribal groups or sets of tribal groups. But those could well be allotted leases, and I don't have the data with me to tell which they are. In Oklahoma we have some of each.

Senator NICKLES. I was going to say it depends on which tribe you're talking about.

Mr. BETTENBERG. Cheyenne, Arapahoe, Chippewa, Cree, Kiowa, Caddo——

Senator NICKLES. Mr. Chairman, I am not wanting to interrupt, but just wondering.

Could you come up with a rule that would say refunds of that $500,000 wouldn't have to be made by the states or the tribes—in other words, they would not have to refund the amount of excess royalty they received—but then make your rule retroactive to basically solve the legal liabilities for that $130 million? If you would make that rule it seems to me that would be a possible solution and it would solve the Indians' problems, solve the states' problems, and solve the potential litigation.

Mr. BETTENBERG. Well, as a general matter, I don't think we could make a rule on that. But on the other hand, if these are allotted leases, my guess is that there is every chance that you couldn't realistically recoup it.

Senator NICKLES. That's true.

Mr. BETTENBERG. And in that case, we would have to go to the General Accounting Office probably for a writeoff. My understanding from Mr. Moyers is that that is the procedure that you would use in those cases. We are talking about $85,000——

Senator WALLOP. Is the writeoff of money something that you had in hand and paid out?

Mr. BETTENBERG. The $85,000 we actually had in hand and paid out to allottees.

Senator WALLOP. That one, but the 130——

Mr. BETTENBERG. We have never had that.

Senator WALLOP. Never had it.

Senator NICKLES. You might spend more than $85,000 trying to collect it anyway. And nobody is trying to do that. I think what we are trying to do is eliminate the potential liability going back in the litigation expense of that $130 million. So, if you come back with a retroactive rule that would solve that problem and maybe exclude the necessity of refunds, either from the states or tribes, maybe that could work.

Mr. BETTENBERG. Well, we have had three recent cases in fact, in which we were overturned by the Interior Board of Land Appeals. They were just simply not recoupable. That was resolved by the Appropriation Committee's adding a small amount to the Bureau of Indian Affairs budget and some language to allow the payments.

Senator MELCHER. Now, Mr. Bettenberg, I want to try to put this in the perspective as I see it because I don't want to oversimplify this. What you are talking about is meeting with the states. Thursday did you say, next week?

Mr. BETTENBERG. Wednesday afternoon.

Senator MELCHER. Pardon me?

Mr. BETTENBERG. Wednesday afternoon.

Senator MELCHER. Of next week.

Mr. BETTENBERG. Of next week.

Senator MELCHER. And if the states say this is okay with us, you are going to feel comfortable you have a deal and that it won't be litigated. Is that correct?

Mr. BETTENBERG. Yes.

Senator MELCHER. All right.

Mr. BETTENBERG. The governors have already signed a letter laying out the parameters of that deal.

Senator MELCHER. Yes. I have looked at their deal, their proposal, or their position I think they worded it.

Mr. BETTENBERG. Yes.

Senator MELCHER. Now, when it comes to the tribes, what you have mentioned is one case where the ruling was that you would have to collect the highest reasonable royalty. Is that correct?

Mr. BETTENBERG. That's correct.

Senator MELCHER. All right. And because of the trust responsibility, you are well aware that suits could follow by either the tribes or the allottees because the trust responsibility goes to both. Correct?

Mr. BETTENBERG. That's correct.

Senator MELCHER. Secondly, there are other leases, lease forms, contracts, with the tribes than there are on Federal leases.

Mr. BETTENBERG. Yes.

Senator MELCHER. In some instances.

Mr. BETTENBERG. Yes.

Senator MELCHER. Yes.

Mr. BETTENBERG. They often define value in slightly different ways.

Senator MELCHER. And those leases are the result—those kinds of contracts or leases are the result of the tribes entering into a different type of agreement authorized by law. That's under the Indian Mineral Development Act.

Mr. BETTENBERG. Or earlier acts.

Senator MELCHER. Or earlier acts. What is the earlier act?

Mr. BETTENBERG. I don't know the name of the law. The recollection is that some of the——

Senator MELCHER. The Sneider Act?

Mr. BETTENBERG [continuing]. Existing statutes I think go back into the 1910s and even before that. There have been Indian leases around for a very long time. The act that you were citing, as I recall, is relatively recent.

Senator MELCHER. The one I'm talking about is a bill I sponsored.

Mr. BETTENBERG. Yes, 1982 I believe.

Senator MELCHER. I believe that's right.

But at any rate, there is a little bit different position with the tribes.

Mr. BETTENBERG. Yes.

Senator MELCHER. You may very well find—I think the Utes are going to testify they have a lot of money coming. And I don't know about the Arapahoes in the Wind River Reservation.

If that should be the case, rather than talking about the $85,000 that you have paid out, they may be talking about millions of dollars that they are going to litigate over because you haven't fulfilled the trust responsibility unless you get a higher price, a higher price for the gas. And I'm talking about the Secretary on the trust responsibility gets a higher price for the gas and, therefore, there would be more money coming in. Is that right? Or due them on the royalty.

Mr. BETTENBERG. That can be the case. I would submit that in the instances on the chart that those are clearly unreasonable and shouldn't be handled in that way. But there are other cases where that can happen. In fact, we are trying to collect on the highest reasonable price in our audits.

Senator MELCHER. Yes. And if we follow the same procedure that is generally allowed, if the Tribes litigate, they get the assistance of the Justice Department if they wanted to accept it. And then they would have their own attorneys, which the Secretary would probably have to allow and pay their private attorneys. Is that correct?

Mr. BETTENBERG. That could well be the case.

Senator MELCHER. And allottees the same.

Mr. BETTENBERG. That could well be the case there as well, yes.

Senator MELCHER. The reason I'm going through this is, Senator Nickles, we may not be talking about the $85,000 or the $500,000. We may be talking about several million dollars—and it could be quite a few million dollars—that might be litigated over. And that cost to the Federal Government paying the private attorneys for the tribes might come to several million dollars. I don't think they are going to win in the long run because I don't think you can get more out of the—I don't think you are going to get it out of the producers. You might get it out of the Federal Government as a breach of trust responsibility. And the Secretary will have to be on the side of the tribe and allottees, and/or. Is that correct?

Mr. BETTENBERG. Well, we are in court with at least one tribe.

Senator MELCHER. Which one?

Mr. BETTENBERG. That's the Shoshone and Arapahoe, Wind River group, on valuation questions.

Senator MELCHER. Yes.

Mr. BETTENBERG. It's not an NTL–5 issue.

Senator MELCHER. And it might simply litigated on why——

Mr. BETTENBERG. The litigation involves what is the highest reasonable price. Just like we have looked at one issue here twice and have come to different conclusions, the judge in this case looked at the case twice and came to different conclusions as well. And from our position we rather preferred his first decision which got the tribe more money than his second, which gets the tribe even more but we thought breached the point of reasonableness.

Senator MELCHER. I only go through this exercise—I don't think we are just talking about $100,000 here in one case or $500,000 in another.

Mr. BETTENBERG. As I recall, our best estimate is about $8½ million involved in tribal and allotted leases.

Senator MELCHER. That is what the Department is saying, $8½ million could be litigated.

Mr. BETTENBERG. Yes.

Senator MELCHER. The tribes are going to say a lot more. And I don't know how much more because we are only going to hear from two or three or a handful of tribes right now. But we might hear from a lot more——

Mr. BETTENBERG. Yes.

Senator MELCHER [continuing]. And a lot of allottees as individuals later on.

Mr. BETTENBERG. What I can say about that is before we audit, all we can do is make a gross estimate.

Senator MELCHER. Yes.

Mr. BETTENBERG. However, if NTL–5 stands as it currently is written and is not changed, then we will get those numbers with exactitude because we will be in auditing each of those. The amounts that we have collected and the amounts that we have on appeal currently are because we have, in fact, gone in and audited those. On other issues we have collected something in the range of $14.3 million on audit on behalf of Indian lessees. We would be doing the same thing, lease by lease, case by case, over the next few years.

Senator MELCHER. When you say NTL–5 stands and implemented as is, are you saying with retroactivity?

Mr. BETTENBERG. No. I'm saying if we were prohibited from making it retroactive and had to enforce the words as they are currently in the regulations.

Senator MELCHER. And without retroactivity.

Mr. BETTENBERG. Without retroactivity we would, in fact, then pursue doing the audits. We would be required to.

Senator MELCHER. And under that scenario is the Department telling us, is the Secretary telling us, that the payments and settlements with the tribes and with the allottees would be paid for out of the Federal share of the royalties?

Mr. BETTENBERG. No.

Senator MELCHER. Out of what then?

Mr. BETTENBERG. What I am saying is that if Congress doesn't allow us to go forward with the retroactive rulemaking, then we would, in fact, be auditing the lessees to see if they had paid in compliance with the FERC ceilings and would be billing them and pursuing those cases through the courts.

Senator MELCHER. Well, it is clear we don't want any retroactivity—I mean, we do want retroactivity.

Mr. BETTENBERG. That's our view as well, sir.

Senator MELCHER. Let me emphasize that. It is clear that the members of this subcommittee want retroactivity on NTL–5.

Mr. BETTENBERG. And we agree 100 percent with you, sir.

Senator MELCHER. All right.

Senator NICKLES. Mr. Bettenberg, let me just throw in a comment too. If you did pursue those audits, I would be one that would be looking at amendments to appropriations bills to prohibit you from doing such. So, that's offensive to me. You don't have too big

a problem out there. The $500,000 is still the problem of the mistakes that have been made to date. But what I hear you saying is if you don't make a retroactive rule, then you are going to be aggressive in pursuing audits to create injustices. And I find that to be absurd. So, I encourage you to make this rule, or else you will see somebody aggressive from the other side of it.

Right now you have some people who are trying to prohibit you from implementing the proposed rule change. You would find some of us that happen to agree with MMS that we ought to be doing things right and on market value who would be trying to prohibit you from enforcing audits to make people pay royalties far in excess of market price.

I hear you saying that if you are not successful in implementing the rule that you are going to be aggressive with audits. And I am kind of bothered by that.

Mr. BETTENBERG. I think that probably the only circumstances in which we wouldn't would be if Congress prohibited us from doing so, as they have for the next 4 months at this point. At some point, I would think even if we didn't move out with our auditors and start doing audits that we would have some sort of restraining order placed against us to follow the rule.

Senator MELCHER. Well, I think what I want to impress, Senator Nickles, on you is that this goes beyond $85,000 or the $500,000 because the tribes are not likely to refrain from litigation unless they get more money. That is what they are faced with—what Interior is faced with.

The settlement may be made with the states that they are going to agree on retroactivity, but I doubt whether the settlement is going to be made with the tribes, that they are going to agree. And so, they are going to insist that they have a higher amount. They can litigate it. The Department of the Interior under its trust responsibility will have to take their side of it. The Federal Government will likely have to pay for the attorneys' fees, hired privately by the tribes or the allottees.

Senator NICKLES. Is that correct?

Mr. BETTENBERG. We often pay for attorney fees. We often provide Federal attorneys. The tribes also often pay attorneys. I think there are quite a number of attorneys for Indian tribes in the room today. I would estimate that over the long haul this whole issue is just simply going to cost the tribes because of that very fact.

Senator MELCHER. There is no way of estimating what the cost of litigation may be. But it would be foolish for us to just think it would be resolved simply because the states sign off. The tribes are not likely to sign off and they are likely to litigate and will. I think we are talking about several million dollars in litigation fees.

Senator NICKLES. The potential is $8½ million, but I——

Mr. BETTENBERG. Apart from the fees.

Senator NICKLES. I understand.

Mr. BETTENBERG. Yes.

Senator NICKLES. But whether or not people would be that insistent on litigating something so they can receive a royalty in excess of market, I don't know. If that was the case, I hope they wouldn't prevail. And I would also hope that our government wouldn't be financing that type of operation.

Senator MELCHER. Well, I'm just stating what I think the Department is in.

All right. Thank you very much, Mr. Bettenberg, for your assistance, for your testimony and your response. There will be other questions submitted.

Mr. BETTENBERG. Mr. Chairman, I appreciate you holding this hearing. Thank you.

Senator MELCHER. All right. Thank you.

Our next witness will be Miles McKinney, Director, Regulatory Analysis for Atlantic Richfield Company. And he is representing Rocky Mountain Oil & Gas Association.

STATEMENT OF MILES McKINNEY, DIRECTOR, REGULATORY ANALYSIS, ATLANTIC RICHFIELD CO., ON BEHALF OF THE ROCKY MOUNTAIN OIL & GAS ASSOCIATION

Mr. MCKINNEY. Thank you, Mr. Chairman. What I would like to do today is you have a copy of the written statement prepared on behalf of the Rocky Mountain Oil & Gas Association in regard to the NTL–5 issue. And rather than go through that and read the entire thing, I would like to read selected portions of it which I feel are very much at the heart of the entire issue.

Senator MELCHER. All right. Please do so and your whole statement will be made part of the record.

Mr. MCKINNEY. Thank you, sir. I would like to begin on page 1 at the lower paragraph.

The Minerals Management Service is to be commended for its efforts to officially modify NTL–5 as proposed by the Federal Register notice of January 3, 1986 and January 15, 1987. Although these notices were the first formal action taken by MMS to modify NTL–5, prior guidance was provided to lessees by MMS officials through direct correspondence as early as 1983 stating that MMS was drafting new valuation regulations and also moving to amend NTL–5.

On July 25, 1986, MMS issued changes to NTL–5 which became effective on August 1, 1986. The changes to NTL–5 rescind prospectively the basic valuation provisions of the notice for all gas produced from onshore Federal and Indian lands with the limited exception of production from wells drilled prior to June 1977 which will be valued under the lessee's arm's length gas sales contract. Thus, the vast majority of gas production is now valued in accordance with the provisions of 30 CFR 206.103 which give MMS flexibility in valuation of production. And this, of course, is the underlying regulation that we look to when we do our valuation.

RMOGA responded February 21, 1986 to the MMS proposed modification to NTL–5. In that comment, we set forth our position that NTL–5 be rescinded retroactive to December 1, 1978, the effective date of the Natural Gas Policy Act. And I think we had a great illustration over here on the chart of exactly what NGPA created when we tried to impose NTL–5 over that.

We wish to explain that position because rescission would provide MMS the flexibility to establish gas royalty consistent with the relevant provisions of 30 CFR and 25 CFR at market-determined values.

If NTL–5 is not modified to include provisions for retroactive valuation determinations, MMS will be permitted to adopt practices contrary to the NGPA. Classifications and ceiling prices under the NGPA were constructed by Congress to encourage production of natural gas. The act adopted the incentive theory of pricing and abandoned the cost basis typical of utility regulation. Dual markets to interstate and intrastate gas were eliminated as well.

Congress also set price ceilings and classifications beyond the authority of administrative agencies. The act made fundamental changes in the theory of pricing, the method of pricing, and the allocation of authority. The NGPA thereby impacted the Department of Interior's ceiling price formula for royalty calculation as set out in NTL–5 which preceded the enactment of the NGPA by a period of more than 18 months.

So, effectively what we are saying here is we had a natural gas policy act passed about 18 months—implemented about 18 months after the effective date of NTL–5. It impacted NTL–5, and we believe really made it somewhat meaningless especially when you get to market values that a producer could not collect.

Now, going on further into the testimony, although RMOGA was disappointed when MMS failed to provide for appropriate retroactive rescission of NTL–5 in its July 25, 1986 rulemaking, we generally support the MMS Federal Register proposal of January 15, 1987 to modify the NTL as a workable solution to the NTL–5 controversy. We think they came forward with a good proposal.

The proposed retroactive dates are an attempt to reflect more closely the value of gas produced in a depressed market. However, the strict application of this proposal using these dates will not be appropriate in all circumstances. The proposed dates do not encompass all prices received under arm's length contracts which are less than the NGPA maximum.

For example, adoption of the MMS proposal would not give relief to producers whose contract never permitted them to receive the applicable ceiling prices. Thus, this proposed modification of NTL–5 only partially alleviates the problem of both MMS and industry in arriving at reasonable values.

Our broad-based membership research found that no single date would be applicable to all contracts within the industry, and it was difficult to determine a specific date for each NGPA category which would be equitable and administratively efficient.

We believe if NTL–5 is not retroactively rescinded, that the MMS proposed dates for the various categories of gas should be adopted as a presumptive effective date, and that lessees should be allowed to overcome that presumption by submitting evidence that they were marketed out, that their arm's length contracts did not allow for collection of the NGPA ceiling prices, or that other circumstances prevented receipt of ceiling prices.

And one thing in there that I would like to point out is in order to collect section 107 or the highest line that we saw on the chart over here, you had to have special language in your contract. And that language was not known until at least 2 years after NGPA was passed. So, it was impossible to collect it. Then you had to go in and ask to have your contract modified. Well, when the gas

market began to decline, nobody wanted to modify the contracts. So, that was one of the boxes that industry is in.

RMOGA asks that NTL–5 be retroactively modified so that MMS can look first to the price the lessee received under its arm's length contract as the best evidence of estimated reasonable value of the product, as provided by 30 CFR 206.103 or the underlying regulations.

Continuing on page 6, RMOGA also believes that it is important for MMS to more specifically address the sale of gas under non-arm's length contracts. And I think Mr. Bettenberg touched on that this morning. If the price established under a non-arm's length sale is determined by MMS to be an unreasonable measure of value, royalty should be based on value as established under comparable arm's length contracts. We believe that you ought to look to other sales in the areas as being a reasonable market value.

In the case of Indian leases, royalties should be valued as always in a manner consistent with the Secretary's duty to the lessor, the lease provisions, the applicable statutes, and the provisions of 25 CFR and 30 CFR, which are, of course, the underlying regulations.

RMOGA urges MMS to carefully consider the valuation discretion conferred on the Secretary of the Interior by the rental and royalty clause in most tribal Indian lands lease agreements. Such discretion clearly includes recognition of amounts realized by the lessee as conclusive evidence of value for royalty computation purposes. Acceptance of arm's length contract prices, relative to the sale of produced gas, is entirely within the discretion of the Secretary.

RMOGA concurs with the recent Department of Interior estimate that refunds under the MMS proposal will be minor in amount. And we have here approximately $2 million and that only is because we had not heard the latest estimate. We had surveyed our membership, and we really could not find anybody who had paid on this because of prior direction.

Continuing on page 7, I would like to say in the event NTL–5 is not rescinded, we submit that MMS' January 15, 1987 proposed modification to the NTL is a workable solution to the current controversy provided that MMS preferred dates are adopted on a presumptive effective date basis. In other words, if you go by the date that they had proposed, and you assume that that was the date that the market did change enough so that it is no longer under that category. However, if a producer could show that they never got the price prior to that, we believe that that ought to also be looked at.

Finally, we would like to say that we have reviewed the July 5, 1987 NTL–5 position agreement by the western states governors of New Mexico, Utah, Montana, Wyoming, North Dakota, and Colorado. We generally concur with the governors' statement. We see no substantive conflict between RMOGA's NTL–5 position and that of the governors'. We think that they are thinking pretty much the same way that industry is.

Moreover, we agree with the June 18, 1987 letter by Senator Don Nickles to Senator Bennett Johnston, signed by 11 other U.S. Senators, expressing the sense of urgency to settle the NTL–5 controver-

sy. We believe that legislation is unnecessary either to correct or delay resolution of the MMS proposed modification of the NTL–5, and we believe that MMS should move forward to correct the regulatory problem.

That concludes my statement.

[The prepared statement of Mr. McKinney follows:]

STATEMENT OF

MILES McKINNEY

representing the

ROCKY MOUNTAIN OIL AND GAS ASSOCIATION

before the

SENATE COMMITTEE ON ENERGY AND NATURAL RESOURCES

SUBCOMMITTEE ON MINERAL RESOURCES DEVELOPMENT AND PRODUCTION

July 10, 1987

Washington, DC

Good morning. My name is Miles McKinney. I am employed by ARCO Oil and Gas Company as its Director of Regulatory Analysis. I am appearing before this hearing on behalf of the Rocky Mountain Oil and Gas Association (RMOGA). I currently serve as Vice Chairman of RMOGA's Finance and Accounting Committee. RMOGA is a regional trade association comprised of individual and company members active in all aspects of the petroleum industry in the states of Colorado, Idaho, Montana, Nebraska, North Dakota, South Dakota, Utah and Wyoming. Most of RMOGA's members are lessees of Federal and Indian lands and represent a majority interest in the total exploration and production activity in this eight-state region. These operators employ some 90,000 people in jobs directly affiliated with the oil and gas industry in the Rocky Mountain area.

The Minerals Management Service (MMS) is to be commended for its efforts to officially modify Notice to Lessees - 5 (NTL-5) as proposed by the Federal Register notices of January 3, 1986 and January 15, 1987. Although these notices were the first formal action taken by MMS to modify NTL-5, prior guidance was provided to lessees by MMS officials through direct correspondence as early as 1983, stating that MMS was drafting new valuation regulations and also moving to amend NTL-5. On July 25, 1986, MMS issued changes to NTL-5 which became effective on August 1, 1986. The changes to NTL-5 rescind prospectively the basic valuation provisions of the notice for all gas produced from onshore Federal and Indian lands, with the limited

exception of production from wells drilled prior to June 1977 which will be valued under the lessee's arm's-length gas sales contract. Thus, the vast majority of gas production is now valued in accordance with the provisions of 30 CFR 206.103 which give MMS flexibility in valuation of production.

RMOGA responded February 21, 1986 to the MMS Proposed Modification to NTL-5. In that comment, we set forth our position that NTL-5 be rescinded retroactive to December 1, 1978, the effective date of the Natural Gas Policy Act (NGPA) (15 USC 3301). We wish to explain that position because rescission would provide MMS the flexibility to establish gas royalty, consistent with the relevant provisions of 30 CFR and 25 CFR, at market determined values.

If NTL-5 is not modified to include provisions for retroactive valuation determinations, MMS will be permitted to adopt practices contrary to the NGPA. Classifications and ceiling prices under the NGPA were constructed by Congress to encourage production of natural gas. The Act adopted the incentive theory of pricing, and abandoned the cost basis typical of utility regulation. Dual markets for interstate and intrastate gas were eliminated as well. Congress also set price ceilings and classifications beyond the authority of administrative agencies. The Act made fundamental changes in the theory of pricing, the method of pricing, and the allocation of authority. The NGPA thereby impacted the Department of Interior's ceiling price formula for royalty calculation as set out in NTL-5

which preceded enactment of the NGPA by a period of more than eighteen months.

When considering whether NTL-5 should establish gas value for royalty purposes based on a ceiling or maximum lawful price set forth in the NGPA, it is appropriate to review the judicial guidance provided in Pennzoil Co. v. FERC, 645 F2d 360 (5th Cir. 1981). In that decision the Court said:

> A ceiling price sets a maximum above which the sales price cannot go, but at the same time does not set a minimum; the sales price, given sufficient economic conditions, can be established at a point below that ceiling. 645 at 372

The Court continued:

> . . . Representative Dingell explained, the maximum lawful price supersedes the contractual arrangement only when the contract price exceeds the maximum lawful price; when the contract price is less than the maximum lawful price, the contractual arrangement continues to govern the party's relationship. . . . Representative Dingell was thus emphasizing that it is in the very nature of the ceiling price concept that the contract controls in the first instance, and that Section 101(b)(9) is not a pricing provision. (emphasis added) 645 at 375

NTL-5 NGPA ceiling price provisions are also inapposite to Superior Oil Co. v. Pioneer Corp., 706 F.2d 603 (5th Cir. 1983) because " . . . the NGPA price ceilings do not give the gas producer a federal right to receive a particular price for its gas". Nowhere does the NGPA provide that the ceiling price should be the market price or in any manner determinative of the value (or reasonable

value). To the contrary, the NGPA, as well as 18 CFR 270.101(b), specifically provides that such a maximum lawful price, or such exemption from such a maximum lawful price, "shall not supersede or nullify the effectiveness of the price established under each contract", NGPA 2(b)(9) 15 USC 3311(b)(9). Thus, it is clear that the NGPA did not, nor was its intent to establish a ceiling market price as value for royalty determination; accordingly, it is improper to use NGPA ceiling prices as indicative of royalty value, except when gas producers were able to collect those prices.

Although RMOGA was disappointed when MMS failed to provide for appropriate retroactive recission of NTL-5 in its July 25, 1986 rulemaking, we generally support the MMS Federal Register proposal of January 15, 1987 to modify the NTL-5 as a workable solution to the NTL-5 controversy. The proposed retroactive dates are an attempt to reflect more closely the value of gas produced in a depressed market; however, the strict application of this proposal using these dates will not be appropriate in all circumstances. The proposed dates do not encompass all prices received under arm's-length contracts which are less than the NGPA maximum. For example, adoption of the MMS proposal would not give relief to producers whose contract never permitted them to receive the applicable ceiling price. Thus, this proposed modification of NTL-5 only partially alleviates the problem of both MMS and industry in arriving at reasonable values. Our broad-based membership research found that no single date would be

applicable to all contracts within the industry and that it was difficult to determine a specific date for each NGPA category which would be equitable and administratively efficient.

If NTL-5 is not retroactively rescinded, RMOGA believes the MMS-proposed dates for the various categories of gas should be adopted as presumptive effective dates and that lessees should be allowed to overcome that presumption by submitting evidence that they were marketed-out, that their arm's-length contracts did not allow for collection of NGPA ceiling prices, or that other circumstances prevented receipt of ceiling prices.

RMOGA asks that NTL-5 be retroactively modified so that MMS can look first to the price the lessee received under its arm's-length contract as the best evidence of estimated reasonable value of the product, as provided by 30 CFR 206.103. To that end, RMOGA recommends that a NTL-5 retroactive modification state the following:

> Royalties based on prices received under arm's-length sales contracts will, in virtually all cases, be accepted for Federal onshore leases. (This philosophy is consistent with MMS policy statements issued since early 1983.)
>
> NTL-5 will be inapplicable and arm's-length sales contract prices will apply to all Federal onshore leases subsequent to the MMS presumptive dates, irrespective of reason (market-out, contract renegotiation, contract limitation, etc.) that NGPA ceiling prices were not received.
>
> Arm's-length contracts will be defined in the traditional sense of contracts between independent, nonaffiliated parties.

RMOGA also believes that it is important for MMS to more specifically address the sale of gas under non-arm's-length contracts. If the price established under a non-arm's-length sale is determined by MMS to be an unreasonable measure of value, royalty should be based on value as established under comparable arm's-length contracts.

In the case of Indian leases, royalty should be valued, as always, in a manner consistent with the Secretary's duty to the lessor, the lease provisions, the applicable statutes and the provisions of 25 CFR and 30 CFR. RMOGA urges MMS to carefully consider the valuation discretion conferred on the Secretary of the Interior by the Rental and Royalty clause in most Tribal Indian Lands Lease agreements. Such discretion clearly includes recognition of amounts realized by the lessee as conclusive evidence of value for royalty computation purposes. Acceptance of arm's-length contract prices, relative to the sale of produced gas, is entirely within the discretion of the Secretary.

RMOGA concurs with the recent Department of Interior estimate that refunds under the MMS proposal will be minor in amount, approximately two million dollars. Thus, MMS should establish a reasonable time frame in which the lessee can recover overpayments from current royalty payments.

In summary, the MMS is charged with the responsibility to assure that royalty values are determined on a reasonable basis and that

there is a reasonable basis in fact to set royalty values. See Supron Energy Corp., et al, IBLA 79-374, GFS (O&G) 75 (1980). The mechanism to do so was provided for many years in the past by 30 CFR 221.47 and is now provided by 30 CFR 206.103, which to a large extent is a restatement of the former regulation. These regulations have been judicially tested and they afford the MMS the necessary flexibility to discharge its responsibility. Indeed, NTL-5, without proper modification, destroys the flexibility to determine royalty valuation on a case-by-case method, which is the only way to establish a reasonable basis in fact to set a value for royalty computation. Thus, NTL-5 should be rescinded.

In the event NTL-5 is not rescinded, we submit that MMS' January 15, 1987 proposed modification to NTL-5 is a workable solution to the current controversy, provided that the MMS preferred dates are adopted on a presumptive effective date basis.

Finally, RMOGA has reviewed the July 5, 1987 "NTL-5 Position" agreement by western states Governors of New Mexico, Utah, Montana, Wyoming, North Dakota and Colorado. We generally concur with the Governors' statement and see no substantive conflict between RMOGA's NTL-5 position and that of the Governors.

Moreover, RMOGA agrees with the June 18, 1987 letter by U.S. Senator Don Nickles (signed by eleven other U.S. Senators) to U.S. Senator Bennett Johnston, in the sense of urgency to settle the NTL-5

controversy. Legislation is unnecessary either to correct or delay resolution of the MMS proposed modification of NTL-5, and MMS should move forward to correct the NTL-5 regulatory problem.

In conclusion, your thoughtful consideration of these comments will be appreciated by the membership of the Rocky Mountain Oil and Gas Association. I welcome your questions or comments with respect to the foregoing testimony.

Senator MELCHER. What would happen if NTL–5 is not retroactively modified?

Mr. MCKINNEY. Well, I think that Mr. Bettenberg probably pretty well pointed out from the producers' side what is going to happen. It will entail litigation.

We believe that one of the things that happened—we believe that NTL–5 does not adequately provide a reasonable value for the royalty share of the production from Federal or Indian leases necessarily. So, we do believe that there will be litigation.

Senator MELCHER. Well, we would like to avoid that.

Thank you very much, Mr. McKinney.

Mr. MCKINNEY. Thank you, sir.

Senator MELCHER. Mr. David Wilson, member of the Executive Committee for the Independent Petroleum Association of America.

STATEMENT OF DAVID W. WILSON, PRESIDENT, INDEPENDENT PETROLEUM ASSOCIATION OF MOUNTAIN STATES, AND MEMBER, EXECUTIVE COMMITTEE, INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA, ACCOMPANIED BY KEN WONSTOLEN, GENERAL COUNSEL, IPAMS

Mr. WILSON. Thank you, Mr. Chairman. My name is David Wilson. I am a member of the Executive and Natural Gas Committees of the Independent Association, and President of the Independent Petroleum Association of Mountain States. I am accompanied today on my left by Mr. Ken Wonstolen who is general counsel for IPAMS in case there are any detailed questions that you might have.

As we have heard today, NTL–5 was originally issued in 1977. It was issued in an totally different era into the gas market. When in November 1978 the Natural Gas Policy Act was changed, we saw a fundamental and permanent change made in the gas market since that time.

Prior to the NGPA, I think ceiling prices tended to set prices for most intrastate gas sales since market prices in most areas would have been higher than those ceilings. They operated as true ceilings during that era.

But following the Natural Gas Policy Act passage, ceiling prices were increased. And as we have heard before, several incentive categories of gas were created. The market was permanently changed, but unfortunately NTL–5 was not changed following that period of time.

Beginning in 1980 it became increasingly clear that market forces were forcing prices actually realized in the market below those ceiling prices established in the NGPA, and it was clear that the MMS was moving toward market-based royalty valuations. Most independent producers operated under a market-based assumption and paid royalties on that basis.

Unfortunately, NTL–5 as originally promulgated was still in places written, and beginning in 1985 we began to see state auditors calculate royalty deficiencies based on unattainable ceiling prices as if they were available.

We have heard a lot of talk today about the retroactivity, which is a very, very major item to the members of the IPAA and

IPAMS. We have heard today about how little money is involved that has actually been paid out, but what might be involved if litigation continues or if NTL–5 is not made retroactive.

As an example of the types of inflated estimates that we have seen as to what money might be due to states or to the tribes, we have included in our statement a calculation by a western state auditor that again is attached to our testimony that calculated hypothetical royalty receipts in 1985 based on either tight gas sand prices of $6.01 or section 102 prices of $4. And they concluded that producers had underpaid royalties in that state by $18.6 million. Yet, not a single pipeline in that state was willing during that period of time to pay those kinds of prices.

If those auditors believed these prices are realizable, then they are absolutely in the wrong field. They ought to be in marketing gas. And I'm sure any of the producers in the business would be very happy to have them running their gas marketing department because we are certainly not able to get those kinds of prices in today's market.

To the chagrin I think of many producers who counted on those higher prices in the past when they drilled those wells, it is very clear that the markets are setting prices today, not the NGPA ceiling prices. Where arm's length transactions are involved, we think it is absolutely imperative that Congress realize it is the producers' benefit to get as high of a price as they possibly can get. We and the royalty owners are in the same position where we both benefit from obtaining higher prices.

In those cases, royalty payments based on arm's length contracts should be based on actual price received. We commend the Department of Interior for adopting this approach.

We should note that our policies call for royalty payments based on net receipts at the wellhead, not gross receipts as some have proposed. We believe that royalty owners are entitled to their share of production at the wellhead cost free. Subsequent costs necessary to allow the gas to be marketed, including gathering charges, dehydration and compression, should be regularly borne we believe by all gas produced at the wellhead including the royalty gas.

The new market-based NTL–5 we believe should be applied retroactively to eliminate the automatic use of the NGPA ceiling prices in look-back audits. This would eliminate some of the many inequities that we feel are sitting currently in cases in the appeal process.

I would like to point out a few of those cases that affect our members. One of IPAMS members was assessed royalty based on tight gas sands prices when his well had been specifically excluded in the regulatory process from receiving tight gas sand designation.

One operator under a 1966 contract could only receive 30 cents per Mcf. Yet, the MMS billed based on a price of $4.11. This resulted in an effective royalty of 140 percent.

Going retroactive as MMS has proposed only to 1982 still leaves that producer with a severe problem because as was mentioned in previous testimony, that producer was never able to receive the ceiling price even from 1978 to 1982 because under the Natural Gas Policy Act if his contract didn't allow the price to go to the ceiling

price, it was not allowed to go there. The contract still operated. So, 1982 still leaves some contracts that would have to pay higher prices than realized under those contracts.

Another member made every attempt to force his purchaser to pay an NGPA ceiling price, including filing a lawsuit under the contract. That resulted in a settlement and a payment of a retroactive adjustment for two years. MMS demanded from that producer increased royalty payments based on five years of retroactive payment which would have resulted in a 30-percent royalty rate during that period of time.

In a third case, the pipeline purchaser used a market-out clause in the contract to reduce the price to $1.09 per Mcf. And that was when the ceiling price for the gas was $6.23. A royalty based on $6.23 resulted in a royalty rate of approximately 100 percent or approaching 100 percent.

A final example is a situation where a gas plant was built in Wyoming to process sour gas to allow oil production to continue from what essentially were oil wells. The producer under an arm's length contract received the maximum price being paid by the operator of that plant, which incidentally never made money. The plant lost money throughout its entire history. Yet, the MMS assessed back royalties in excess of the gross proceeds received by the producer. That plant is now not operating.

The ultimate irony in this is that some would have us pay royalties on higher prices than we can receive on Federal acreage when it has been Federal policies that have been largely responsible for pushing many producer prices lower on that Federal acreage. The Natural Gas Policy Act, as we all recall, was passed to try to overcome 24 years of Federal price controls. It was the Natural Gas Policy Act that encouraged incentive prices which frankly led to overdevelopment of marginal gas sources which are now the cause of an oversupply of gas in that area. This was a natural reaction to coming out from under 24 years of price controls since 1954.

It is the Federal Government and existing laws that have protected, frankly, the pipeline transportation rates which are now higher than producer prices in most areas of the country. These noncompetitive and protected transportation rates are serving to directly reduce wellhead prices since gas has to aggressively compete at the burner tip in order to retain markets. This is referred to as net-back pricing, which means producers get what is left after everyone else takes their protected cut of the revenues received.

This has resulted, frankly, in prices in the Rockies, where most Federal land is located, being well below prices seen in other parts of the country. We saw on the chart today from Interior that—from the MMS that they were using a price of $2.25. In today's market in the Rockies if you can get a $1.09, you are doing very well. Our prices are running between 30 and 50 cents below spot prices in other parts of the country which are a direct result of Federal policies in the natural gas area.

It is the Federal Government that has approved natural gas imports on terms and rates that have encouraged use of imports in major markets even though domestic gas that was available was cheaper than those imports. Enough blanket import authorizations

have been approved by the administration to serve as a severe overhang on domestic prices in the Rocky Mountain area.

For example, currently 11.4 trillion cubic feet of imports have been approved to come into the United States even though our total market is about 16 trillion cubic feet. That overhang is certainly resulting in lower prices in the Rocky Mountain area.

I am not here today to address these issues specifically, but only to point out that it is absurd and confiscatory to, on one hand, have all branches of the Federal Government pursuing policies that have resulted in strong downward pressure on producer wellhead prices while, on the other hand, have policies that have demanded that royalty payments be based on higher unrealizable prices at the same time.

We only ask that regulations recognize that we try to get prices as high as we possibly can as producers and royalties should be based on those prices where arm's length contracts are involved. If this takes legislation to put this into effect, then we would certainly support that legislation.

Thank you.

[The prepared statement of Mr. Wilson follows:]

TESTIMONY OF THE

INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA

INDEPENDENT PETROLEUM ASSOCIATION OF MOUNTAIN STATES

TO THE

SENATE SUBCOMMITTEE ON MINERAL
RESOURCES DEVELOPMENT AND
PRODUCTION

JULY 10, 1987

David W. Wilson
President of the Independent Petroleum
Association of Mountain States and
Executive Committee Member of the Independent
Petroleum Association of America

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For the record, I am David W. Wilson of Denver, Colorado. I am appearing today on behalf of the Independent Petroleum Association of America (IPAA) and the Independent Petroleum Association of Mountain States (IPAMS).

The IPAA is a national association representing the estimated 12,000 independent oil and natural gas producers in the United States. IPAMS is a regional association representing the independent explorers/producers who live or work in the Rocky Mountain region. The members of both associations account for 90 percent of all wildcat drilling and 85 percent of all drilling, which results in a majority of the significant oil and natural gas discoveries. Independents generally have only one profit center -- the sale of oil and natural gas at the wellhead -- and one place for reinvestment of capital, exploration and development of new reserves. They do not refine, transport or market oil and natural gas as a principal business.

As the President of IPAMS and Executive and Natural Gas Committees member of IPAA, I have spent a great amount of time in dealing with issues generally involving natural gas policy matters. Recently, of course, I have devoted considerable time and thought to the various facets of the issue before us this morning. The NTL-5 situation obviously is extremely complicated and we are grateful to this Committee for providing the opportunity to delve into the subject in detail.

A. STATEMENT OF POLICY (see Attachment A)

IPAMS and IPAA have long maintained that royalties should be based on the net receipts to a producer under an arms-length contract. This position is consistent with our free enterprise system, which relies on the marketplace, not the bureaucracy, to establish value. Further, it is clear that, in an arms-length transaction, the producer is seeking to maximize his return on production, resulting in a commonality of interest between the producer and royalty owner. IPAMS and IPAA commend the Department of Interior for adopting this common sense approach in its proposed comprehensive product valuation guidelines.

Problems may arise where sales occur in non-arms-length situations. Identification of such instances can be achieved by disclosure requirements or, perhaps, by increased scrutiny of sales below a benchmark price representative of similar, arms-length transactions. MMS' hierarchy of value determination methods for non-arms-length transactions appears to be a reasonable approach in such situations. In any case, this in not an issue which greatly concerns the independent producer members of IPAMS and IPAA.

Please note that the IPAMS-IPAA policy calls for royalty determination based on net receipts. MMS' proposed rule applies royalties to gross proceeds, with some allowance for transportation and processing costs. IPAMS and IPAA assert that royalty owners are entitled to their portion of production at the wellhead, free and clear of cost. Subsequent costs of making such gas marketable, including gathering, dehydration and compression should be ratably borne by the royalty owner, as if the gas were taken "in-kind" at the wellhead. Indeed, the IPAMS-IPAA policy calls for good-faith royalty valuation disputes to be resolved via the exercise of in-kind royalty provisions.

In summary, it is absolutely unfair to ask producers to pay royalty based on some bureaucratic value determination. The marketplace, not bureaucratic fiat, is the determinant of product value.

B. NTL-5 RETROACTIVITY (see Attachment B)

IPAMS and IPAA strongly support MMS' proposal to retroactively apply NTL-5, as amended in July, 1986. This would eliminate the automatic use of NGPA incentive prices in the "look-back" audit process. Such reliance on arbitrary price "ceilings" has resulted in numerous instances of royalty inequity. In one instance, an IPAMS member in Grand Junction, Colorado was assessed back royalty based on NGPA "tight sands" incentive price when his production had been specifically excluded from the nearby "tight sands" area designation. In other words, this producer was told to pay royalty on a price he could not legally collect.

Royalty auditors, in general, have simply refused to recognize that the natural gas marketplace does not universally operate according to federal price levels. Moreover, the NGPA incentive prices established in 1978 do not correspond to the Federal Power Commission price ceilings in place when NTL-5 was adopted in 1977. FPC ceiling prices, under the Natural Gas Act, were based on considerations of cost and return. On the other hand, NGPA incentive prices as administered by the FERC, were designed to stimulate gas production under the erroneous assumption that the nation faced a gas shortage. NTL-5 was never amended to recognize this difference, and royalty auditors continue to view FPC ceiling prices and FERC incentive prices as interchangeable. (see discussion at B-4 to B-5)

In summary, if it is fair to utilize the marketplace as the determinant of royalty value prospectively, it is also fair to do so retroactively. NTL-5 has been based on a defective premise since the enactment of the NGPA in 1978 and cannot be justified as a value methodology for audit purposes.

C. ROYALTY INEQUITY (see Attachment C)

The MMS royalty audit process, particularly as administered by state auditors under a delegation of authority, has resulted in numerous instances of unfair treatment of producers. IPAMS and IPAA believe that these producers will ultimately succeed on appeal. However, this time-consuming and costly process is wasteful of both public and private resources. Hopefully, retroactive revision of NTL-5 will ameliorate the situation.

The examples included in Attachment C are illustrative of the problem. In the first case a producer was billed $1,920 ($10 per report line) for a report which was mailed timely but received late. More important, the actual royalty payment was received before the due date. As a result, the company indicates that it will have to start "estimating" production, wasting its staff resources and those of MMS when the inevitable adjustments have to be made.

In the second instance, a producer made diligent attempts, including the filing of a lawsuit, to force a gas purchaser to pay a higher NGPA price. A settlement was reached which resulted in a two-year retroactive price adjustment. MMS, however, demanded an adjusted royalty retroactive to five years. This resulted in an effective royalty rate of 30 percent on the production in question.

The third example concerns a well whose gas was "released" by the pipeline under a "market out" clause. The NGPA incentive price for this category of well was $6.23/MMBtu at the same time the gas could only be sold to the "spot" market at $1.09/MMBtu. A strict application of NTL-5 would result in an effective royalty approaching 100 percent. Do state auditors believe that a producer will continue to producer a well where the royalty alone confiscates his entire gross proceeds?

The final example relates to a situation where sour, acidic gas was being produced, in unmarketable quantities, by oil wells in Wyoming. Eventually a $2 million processing facility was built in a futile attempt to produce marketable gas. This plant never made a profit, or even recovered the initial investment. The producer, under an arms-length contract, received the maximum price paid by the plant operator to any supplier. Nevertheless, MMS, via the Wyoming auditor, assessed back royalties in excess of the gross proceeds received by the producer. The processing plant is now defunct.

IPAMS and IPAA expect royalty auditors to be aggressive, but not absurd.

D. SCOPE OF THE PROBLEM (see Attachment D)

Exaggerated claims are being made by certain state, tribal and "public interest" groups about gross "undercollection" or "underpayment" of federal royalties. Figures like 21 percent underpayment, equivalent to $1-2 billion in outstanding royalties are being tossed about. Let's examine how these figures are derived.

First, as reported to the Royalty Management Advisory Committee by the PAAS study group, 90-99 percent of royalty disputes are valuation-related, not a result on under-reporting of production. As MMS Director Bettenberg has testified in the past, these wild allegations are suspect because they: are based on unrepresentative audit samples; excluded audits which detected overpayments or no problems; and, included complex audit findings on appeal or in litigation and which may be decided in favor of the payor. MMS estimated the royalty "underpayment" rate at around 3 percent -- before proposing the retroactive adjustment to NTL-5.

At pages D-3 to D-5, is an example of the continuing misinformation being promulgated by some in the audit community. The Wyoming auditor has calculated the royalty difference between the NGPA Sections 107 and 102 incentive prices for 1985 and the actual prices paid to producers in the marketplace via pipeline "market-outs." He concludes that producers have "underpaid" their royalty obligation to the tune of $18.6 million. This is an illusory figure, based on bureaucratic incentive prices with no relation to the realities of the marketplace.

TESTIMONY OF THE
INDEPENDENT PETROLEUM ASSOCIATION OF MOUNTAIN STATES
Submitted to the
Senate Committee on Energy and Natural Resources
May 20, 1986
Re: Comprehensive Natural Gas Legislation

Executive Summary

IPAMS, the regional trade association representing 1500 independent producers and associated companies in the eleven Rocky Mountain States, calls on the Congress to enact comprehensive natural gas legislation encompassing the following basic elements:

- •mandatory open access to pipeline transportation systems
- •removal of remaining wellhead price controls
- •elimination of natural gas demand constraints
- •an end to regulatory bias favoring imports
- •royalty assessments based on actual producer receipts
- •antitrust exemption for independent producer marketing co-ops

Immediate action on this legislative agenda is urgently needed to preserve the independent segment of the domestic natural gas industry. The current lack of access to markets, coupled with irrational and discriminatory regulatory policies, is distorting the natural gas system of this country to the detriment of both producers and consumers.

Background

Independent producers in the Rockies have been especially hard hit by the current slump in the natural gas market. Rockies producers frequently explore and drill for gas in frontier regions, incurring higher finding costs. Much of the region's gas is from deep or "tight-sand" horizons and is consequently more expensive to produce. Further, only five interstate pipelines (Colorado Interstate Gas, El Paso, Cities Service, Panhandle Eastern and Northwest Pipeline) are available to producers in the entire eleven-state IPAMS region.

"...Rocky Mountain independents are selling less than 40 percent of their deliverable supplies..."

The effect of this situation is apparent in a recent Independent Petroleum Association of America survey of independent gas producers which indicates that Rocky Mountain independents are selling less than 40 percent of their deliverable supplies, compared to a national average for independents of over 60 percent. Entire producing basins are virtually "shut-in." Coupled with the drastic decline in crude prices, the reduction in the cash flow to independents in the Rockies threatens their very existence.

IPAMS members are not seeking government "bail-outs." They simply seek an opportunity to compete on a "level playing field," under a rational system of regulation, and with access to transportation and markets. If the Congress will unleash the free enterprise energies of the Rockies independents in this fashion, they will make an important contribution to future domestic energy security.

Following are the necessary components of comprehensive natural gas legislation.

Receipts-based Gas Royalties

Since the enactment of the NGPA in 1978, federal gas royalties have been based (under "NTL-5") on the highest possible value—NGPA ceiling price, highest field price or contract price—regardless of the producer's actual receipts. This represents an unwarranted departure from our nation's free enterprise principles and fails to recognize the commonality of interest between the producer and royalty owner. After all, both benefit when the producer, by nature, seeks to maximize his sales revenues.

continued on page 10

continued from page 9

Today, it is rare for producers, especially independents, to collect NGPA ceiling prices, or even full contract prices. Pipelines have used "force majeure" or "market-out" contract clauses to unilaterally reduce takes and prices, or to simply walk away from contracts. Wellhead prices have dropped substantially.

Assessing federal royalties based on illusory values penalizes producers already strapped for cash flow. Approximately $150 million in back royalties and penalties have been assessed to the industry, most of which is being contested. However, while the appeals process grinds on, the producer must submit the contested amount or, if he can obtain one, post a bond.

The Minerals Management Service has begun a process to revise the federal royalty rates on two fronts. It is considering repeal or revision of NTL-5, while also engaged in an effort to develop comprehensive new guidelines. Initially, MMS has proposed reliance on "arms-length" contract prices, a standard IPAMS supports. However, MMS would assess such royalty even if the producer was unable to collect his contractual price, unless the producer initiated litigation against the purchaser. This is a "Hobson's choice" and an infeasible approach.

"...an avenue for co-operative marketing must be provided."

Further, MMS asserts a right to gross sales prices, ignoring costs the producer may have to bear to gather, process and transport the gas. It claims a right to take-or-pay amounts on gas remaining in the ground. And, it wants a share of the enhanced product value derived from manufacturing gas liquids. IPAMS asserts that the federal government, as royalty owner, should stand in no better position when it collects royalty based on product sales than it would if it received its royalty share "in kind," at the wellhead.

Therefore, IPAMS urges Congress to direct MMS to adopt a royalty standard based on a producer's actual net receipts under an arms-length contract. In addition, relief from excess royalty liability imposed under NTL-5 should be granted retroactive to the enactment of the NGPA.

RESOLVED:

Royalty determination for natural gas production should be based on the actual, net wellhead receipts to a producer under an arms-length transaction. Costs of making such gas marketable, as well as other associated costs, should be allowed as a deduction from the gross proceeds to the producer. Royalties should not be imposed on take-or-pay amounts, received or not, until the covered gas is actually severed from the ground. Nor should royalty obligation accrue to unmarketable gas which is flared in association with oil production from wells operated in compliance with the regulations of state conservation commissions.

Further, royalty agencies must register an objection to a producer's royalty determination within a reasonable time, or be bound by it. Where a good-faith dispute is irresolvable, in-kind royalty clauses should be utilized.

Approved by the IPAMS Executive Committee on August 3, 1985.

Independent Petroleum Association of Mountain States
1214 DENVER CLUB BLDG. • DENVER, COLORADO 80202-4167 • (303) 623-0987

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• Executive Committee

March 15, 1987

Minerals Management Service
Building 85
Denver Federal Center
P. O. Box 25165 - Mail Stop 651
Denver, CO 80225

Attention: Mr. Dennis Whitcomb

Re: Comments on Notice of Proposed Modification to Notice to Lessees-5;(52 FR 1671)

The Independent Petroleum Association of Mountain States (IPAMS) represents over 1200 independent oil and gas operators and related businesses in the Mountain West, including Arizona, Colorado, Idaho, Montana, Nebraska, Nevada, New Mexico, North Dakota, Oregon, South Dakota, Utah, Washington and Wyoming.

INTRODUCTION:

IPAMS supports the proposal by the Minerals Management Service (MMS) to change the effective date of the modifications to Notice to Lessees-5 (NTL-5) which were published in the Federal Register on July 25, 1986. This proposal for retroactivity should be applied without limit to all lands under the royalty accounting jurisdiction of the MMS. The MMS is to be commended for recognizing the inequity of basing royalty payments on Natural Gas Policy Act (NGPA) incentive prices when such prices were not attainable in the marketplace. Moreover, NGPA "incentive" prices are not equivalent to the Federal Power Commission "ceiling" prices in effect when NTL-5 was issued on May 1, 1977. Fairness and equity to both operators and royalty owners will be achieved through this retroactive change.

DISCUSSION:

IPAMS believes that NTL-5 should be amended retroactively, as appropriate in individual cases, without limit. The adoption of NTL-5, in 1977, immediately created a potential problem in terms of charging royalties based on the higher of FPC ceiling prices or contract prices. The problem accelerated when NGPA incentive prices replaced FPC ceiling prices and producers unable to obtain these prices began to be assessed royalties on monies never received..

Attempting to identify arbitrary dates for different NGPA pricing categories, as is suggested in MMS's proposal, will not redress NTL-5's original, defective premise. This is especially so in the Mountain West where, because of the lack of a well-developed pipeline system, producers frequently were unable to obtain maximum lawful prices even prior to the NGPA. Producers negotiated the highest contract price they could obtain in the marketplace, which benefits royalty owners, as well. The problem worsened under the NGPA because of the widespread utilization of "market-out" clauses by pipelines.

Therefore, trying to identify arbitrary dates which would treat fairly all producers adversely affected by the application of NTL-5 is futile. NTL-5 must provide for the collection of royalties based on actual producer receipts under arms-length contracts back to its inception. Affiliated transactions should be dealt with on a case-by-case basis, also retroactive to May 1, 1977.

INDIAN TRIBES AND ALLOTTEES:

In the interest of uniformity, simplicity and fairness, NTL-5 should retroactively apply to Indian tribal and allottee lands. Where federal rules govern federal lands, as well as Indian lands, they ought to apply consistently. Political considerations, however, may dictate special solutions to prevent undue hardship on Indian tribes and allottees.

IPAMS' suggested approaches, in order of preference, are to:

1. Apply NTL-5 retroactively to all Indian lands .

2. Apply NTL-5 retroactively to all Indian lands but disallow cash refunds of royalties paid to Indian allottees.

3. Apply NTL-5 retroactively to all Indian lands but disallow cash refunds of royalties paid to Indian tribes and allottees.

By disallowing cash refunds of royalties paid, tribes and allottees would not feel the full impact of the retroactive change to NTL-5. Refunds would only be made via a credit against future royalties, spread over some appropriate time period. Royalties under appeal, but not actually paid, would be treated the same as other federal royalties.

SUMMARY:

IPAMS has consistently asserted that royalties should be based on the realities of the marketplace. The only way to assure this is to make NTL-5 as amended on July 25, 1986, retroactively effective to May 1, 1977. These disputed amounts rightfully belong to the oil and gas operators who took the risk to discover and develop our nation's energy resources. As national reserves continue to decline, and as imports and the federal trade deficit continue to climb, domestic exploration is even more crucial. Royalty rules which unfairly penalize producers and unjustly enrich royalty owners will not serve the national interest.

Thank you for your consideration of our comments.

Sincerely,

David W. Wilson
President

Ken Wonstolen
Kenneth A. Wonstolen
Executive Director

Attachments

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RECEIVED ... 1 - ...87

March 9, 1987

Minerals Management Service
Building 85
Denver Federal Center
P.O. Box 25165
Mail Stop 651
Denver, Colorado 80225

Attention: Mr. Dennis Whitcomb

Re: Proposed Modification to
NTL-5

Dear Mr. Whitcomb:

We represent a number of oil and gas producers who operate on federal and Indian lands and submit these comments to the proposed revision of NTL-5 on their behalf. Generally, we fully support your proposal to make retroactive the more reasonable valuation criteria for natural gas.

There is ample legal and policy justification for the revision proposed on January 15, 1987 and, in fact, in our view, NTL-5 should be repealed entirely back to the date of enactment of the Natural Gas Policy Act of 1978. NGPA price ceilings, to the extent that they were obtainable, should simply be another factor considered in the valuation criteria set forth in 30 C.F.R §206.103. As you know, NTL-5 was issued in 1977 and was based upon the maximum ceiling prices for gas established by the Federal Power Commission under the Natural Gas Act. Ceiling prices for natural gas established by the Federal Power Commission were generally intended to limit natural gas prices. They were established in what were basically rate proceedings, with considerations of cost and a fair return to the lessor, the lessee/operator, the pipeline company and the distributing public utility. The FPC's ceiling rates, accordingly, had some rational relationship to value for royalty purposes.

On the other hand, the ceiling rates established under the Natural Gas Policy Act of 1978, particularly Section 107 and 108 prices, were based on a public policy to provide incentives for

production of high cost natural gas and continued production of gas from stripper wells. See, Legislative History-Natural Gas Policy Act of 1978, U.S. Code Cong. & Adm. News, 95th Cong. 1978, Vol. 7 at 9003 through 9005. To the extent that the natural gas market permitted producers and lessees to market their gas at such maximum prices, the value of the gas was properly determined by the NGPA ceiling prices. The Natural Gas Policy Act was intended to provide a comprehensive national energy conservation policy which would reduce energy use and encourage exploration and development of natural gas by permitting prices to rise. It was never intended as a basis for definition of the "value" of natural gas for royalty purposes under the Mineral Leasing Act of 1920. The Natural Gas Policy Act, together with a general slowdown in the economy resulted in what is described as the "gas bubble," a current excess of supply over demand, with the result being a decrease, and sometimes a substantial decrease, in natural gas prices. The NGPA ceiling prices did not represent the "value of the gas" as that price often could not be obtained in the market. Consequently, NTL-5 represents a policy of "value" determination based on the erroneous concept that there would always be a shortage of natural gas and that the lessee/producer would always be entitled to, and could always obtain, the ceiling price for its natural gas. However, as the proposed revision announced on January 15, 1987 notes, that premise was a faulty one, as subsequent market developments have borne out.

Despite the transfer of the Federal Power Commission's authority to the Federal Energy Regulatory Commission and the change in the regulatory pricing structure by the adoption of the Natural Gas Policy Act of 1978, the U.S. Geological Survey (and subsequently the Minerals Management Service) never amended NTL-5 and continued, without notice or comment, to treat the references in NTL-5 to the Federal Power Commission as interchangeable with references to the Federal Energy Regulatory Commission. While the agencies' authorities may be parallel, the ceiling prices referenced in NTL-5 as originally promulgated are totally different from the ceiling prices set by the Federal Energy Regulatory Commission under the direction of the Natural Gas Policy Act. The U.S. Supreme Court has recognized that the Natural Gas Policy Act resulted in a totally different pricing climate than had existed under the Natural Gas Act. For example, in Public Service Commission of New York v. Mid-Louisiana Gas Co., 463 U.S. 319 (1983), Justice Stevens explained that "by enacting the Natural Gas Policy Act of 1978, Congress comprehensively and dramatically changed the method of pricing natural gas produced in the United States." 463 U.S. at 322. Later in the same

opinion, Justice Stevens explained that "in each category of gas, the statute explicitly establishes an incentive pricing scheme that is wholly divorced from the traditional historical-cost methods applied by the [Federal Power] Commission in implementing the Natural Gas Act." 463 U.S. at 333. These discussions of the purpose of the Natural Gas Policy Act by the Supreme Court dislose the total lack of a logical underpinning for the continued reliance on NTL-5 for valuing gas produced from federal and Indian leases.

Since market conditions did not noticeably begin to deteriorate until early 1982, perhaps reliance on NTL-5 until that time was not unreasonable, as the FERC ceiling prices were generally obtainable in the market. The delay in change of market conditions subsequent to the enactment of the Natural Gas Policy Act does not mean that the unarticulated substitution of "FERC ceiling prices" for "Federal Power Commission ceiling prices" in NTL-5 was justified in reason or logic. For that reason, we believe it would be theoretically more consistent to simply repeal NTL-5 retroactive to the adoption of the Natural Gas Policy Act of 1978. Certainly, 30 C.F.R. §206.103 would justify the Minerals Management Service in looking at FERC ceiling prices as an indicator of value, but the single-minded reliance on that one factor for valuing natural gas for royalty purposes is arbitrary and capricious.

If the Minerals Management Service declines to accept our recommendation that NTL-5 be repealed retroactively to the effective date of the Natural Gas Policy Act of 1978, we have no serious objections with the dates chosen in the proposal published on January 15, 1987 as general indicators of the points in time at which market conditions deteriorated substantially and forced pipeline purchasers to market-out under the various categories of gas. However, we urge that the dates selected be presumptive dates rather than arbitrary deadlines. For example, some purchasers, because of relatively poor bargaining position, may have been forced to market-out earlier than the indicated dates for a particular category of gas. There, the sale price under an arm's-length contract should govern. Similarly, if a particular seller was able to receive the ceiling price beyond the dates set forth in the notice, he should, of course, pay royalty based on that price.

Again, we commend the Minerals Management Service for acknowledging the inequitable situation that exists if look-back audits arbitrarily rely on NGPA ceiling prices as the sole indicator of value of natural gas produced from federal or Indian

lands. However, we believe that NTL-5 should be repealed completely, effective as of the date of enactment of the Natural Gas Policy Act of 1978, and the NGPA ceiling prices should be used only as an indicator of value, where appropriate under 30 C.F.R. §206.103.

Thank you for your consideration of these comments.

Very truly yours,

POULSON, ODELL & PETERSON

Laura L. Payne

Laura L. Payne

LLP:cjb

Western Production Company
OIL AND GAS PRODUCERS

P. O. BOX 2076
RAPID CITY, SD 57709
(605) 342-4818

November 12, 1986

Mr. James R. Detlefs, Chief
Fiscal Accounting Division
Minerals Management Service
P.O. Box 5760, MS 652
Denver, Colorado 80217

Dear Mr. Detlefs:

Pursuant to the provisions of Title 30, Code of Federal Regulations (CFR), Part 290, Western Production Company (77140) hereby appeals Invoice No. 89606450, a copy of which is attached hereto. This invoice reflects a penalty of $1,920.00 ($10.00 per line) for a report which was received the morning of the second day after it was due.

Western Production Company was not able to submit the report on time because we received the gas statements necessary to complete the report late for that month. The gas statements were received late in the afternoon on Friday, July 25, 1986. This allowed us four (4) working days within which to not only complete the report, but also to have it in MMS' Denver office. The report was mailed before 5:00 p.m. on Wednesday, July 30, 1986, and was not received by MMS until Monday, August 4, 1986. The payment due for that report was received by MMS before the due date and we feel an assessment of $1,920.00 is excessive considering the fact that the report was less than two days late and the money had been received by MMS on time.

Because of the difficulties involved with estimating gas production and the fact that we had always received the gas statements in time to file our reports, there had been no reason to estimate the gas. However, due to the magnitude of the penalties now involved, we have decided to go ahead and estimate the gas. Hopefully, this will alleviate the possibility of additional penalties due to late filings.

We had previously felt that by estimating the gas there would be a greater chance of estimating incorrectly thereby increasing the possibility of being assessed penalties plus interest. All of the wells reported by Western Production Company are located in the Finn-Shurley Field in Weston County, Wyoming, and any projections made with respect to production can only be made consistent with the gas-oil-ratio which, at best, is difficult to project. The wells are on an oil decline curve of approximately 50% the first year, 40% the second year, 30% the third year, 20% the fourth year and 10% thereafter. The gas-oil-ratio increases as the oil production declines and the

ratio varies from well to well. In addition, if a well has been shut-in for an extended period of time, the gas production will increase for a period after it starts producing again. As you can see, there are several variables which have to be taken into consideration when estimating gas which in turn increases the chance of an incorrect estimate.

Furthermore, we have always done our best to cooperate with MMS in order to file our reports on time and in accordance with the regulations and feel the same consideration should be given us when an incident occurs that is beyond our control or done inadvertently. Like everyone else in the oil industry, we have cut back on our staff and are doing the best we can to keep our operations running smoothly and to comply with all government regulations. The wells we are producing are marginal stripper wells and in order to continue to operate them with the current oil prices we need to keep expenses at a minimum. This unfortunately means less personnel, which in turn means a heavier workload on those remaining thereby increasing the chances for clerical errors and inadvertent late filings. In addition, penalties of this size are not only affecting the economical feasibility of the wells, but are also placing unreasonable pressures on the individuals preparing the reports.

If you have any questions or require additional information, please contact us.

Sincerely,

WESTERN PRODUCTION COMPANY

Dee Blair

Dee Blair
Land Manager

Attachment (1)

U S DEPARTMENT OF THE INTERIOR
MINERALS MANAGEMENT SERVICE
ROYALTY MANAGEMENT PROGRAM

DATE: 10/23/86
PAGE: 1

PAYOR
BILL FOR COLLECTION

INVOICE NUMBER: BILL 89606450

FEDERAL/INDIAN INDICATOR: F

BILL TO:

77140 WESTERN PRODUCTION CO.
P.O. BOX 2076

RAPID CITY SD 577090000

REMIT TO:

MINERALS MANAGEMENT SERVICE
ROYALTY MANAGEMENT PROGR.
P. O. BOX 5810 T.A.
DENVER CO 80217000

ASSESS NUM/DESC SALES MO	REF DOC ID DAYS	AID/PRODUCT/SELL-ARR RATE	 ASSESSMENT AMOUNT	 PEN TYPE	 AMOUNT I
001 NON-RESP 06/86	000	0.000000	$ 0.00	P	$ 1,920.

ASSESSMENT FOR LATE OR NON-REPORTING VIOLATION
PER 30 CFR 218.56.

DI1040
JUL '83

INVOICE TOTAL: $ 1,920.
INVOICE DUE DATE: 11/28/86

AREA CODE 303
PHONE 573-6031

J. C. THOMPSON
INDEPENDENT OIL OPERATOR
410 - 17TH STREET, SUITE 1308
DENVER, COLORADO 80202

January 20, 1987

TO: Barry Snyder, Chairman IPAMS Natural Gas Committee

FROM: J.C. Thompson

RE: Proposal Modification to MMS NTL-5

This memo is being written in accord with the Jan. 14 memo from Pam Gerdeman advising of the opportunity for IPAMS to comment on the captioned matter. I will not be able to attend the Committee meeting on February 2.

My comments relate to the aspects of 1) effective dates for proposed retroactive modifications, 2) the "reasonable" aspect of royalties, and 3) a proposed method of recovering excessive royalty payments from the Government (as opposed to Indian allottees).

1) It was stated that MMS may consider market conditions and other factors in determining royalty values (4310-MR, Jan 8, 1987). One of the basic assumptions implicit in MMS considerations appears to be that the gas market changed some time in 1982 to 1983 from a situation where producers could demand and receive NGPA ceiling prices to a situation where gas purchasers dictated the price. While this assumption may be fair in the general sense, it is not a fair assumption in all cases. For example, producers in southeast Colorado selling to Peoples Gas Company (division of Northern Natural Gas Company) negotiated, and in one case actually filed a lawsuit, to obtain NGPA Section 103 prices to replace a Section 106 contract. Settlements were reached in March 1982 and July 1983 which provided for retroactive collection of Section 103 prices back to June 1, 1981. Peoples would not pay this producer retroactive higher prices for an earlier date.

Following the settlements, MMS demanded royalty based on Section 103 pricing back to December 1, 1978. This demand was made in the face of showings that negotiations between producer and purchaser were at arm's-length, were sometimes acrimonious, and did occur after filing of a lawsuit by one producer to collect Section 103 prices. These negotiations could accurately be characterized as the best efforts of small producers to obtain the best price available from a subsidiary of a large gas transmission company. If certain large producers selling

to this purchaser obtained higher prices, then other factors entered into those negotiations. Small producers, as is well known, do not have the same marketing power as large producers.

2) MMS states in its advisory that it is allowed to "...consider market conditions and other factors..."; also that certain court cases "...require that the royalty values established be 'reasonable'." In the example cited above, the royalty rate is 30%. An example for January 1980 is that the producer received a price of $1.74/MCF (adjusted for BTU) but MMS demanded and received royalty based on the Section 103 price of $2.40/MCF (adjusted for BTU). Thus, the effective royalty for MMS was 41.4%. The calculation is as follows:

Production Mo.	Contract Gross Amount		Royalty Amount	
	Value Rec'd	MMS Value Claimed	Paid	MMS Claim
Jan. 1980	$10,062.72	$13,872.00	$3,018.83	$4,161.60

Effective Royalty = $4,161.60/$10,062.72 = 41.4%.

By making this claim, MMS collected 37.9% more royalty than it would otherwise have been entitled. Yet the producer used every effort short of continuing a lawsuit to completion in order to obtain a higher price prior to June 1, 1981.

As related above, the actions of MMS were not reasonable. MMS should accept the price received by the producer when diligent efforts have been used to negotiate a price. Otherwise, MMS becomes a silent partner who does not make known his wishes until negotiations are completed.

3) MMS has requested comments about the method of collecting retroactive adjustments for royalty overpayments, and the question of collecting from Indian lessors is posed. This memo contains no comment regarding Indian lessors; however, MMS should address affirmatively the question of reimbursing royalty overpayments on BLM lands. The MMS should cause the U.S. Treasurer to issue checks within 60 days of a decision for the full amount of overpaid royalties. It is sufficient damage to the producer that interest is not collectible from MMS; the damage should not be compounded by additional delays of the type proposed for Indian lessors.

Please contact J.C. Thompson if you have any questions.

(2) Placed in the perspective of Fenis memo, the Indian royalty overpayments represent only 5% of the total problem, so let us keep that in mind when commenting.

BENSON-MONTIN-GREER DRILLING CORP.

221 PETROLEUM CENTER BUILDING, FARMINGTON, NM. 87401 505-325-8874

August 3, 1986

Mr. William Bettenberg, Director
Department of the Interior
Minerals Management Service
18th & C Streets, NW
Room 1442
Washington, DC 20240

Re: VALUE OF GAS FOR ROYALTY PURPOSES:
NTL-5 AND MODIFICATION EFFECTIVE
AUGUST 1, 1986

Dear Mr. Bettenberg:

We in industry are appreciative of the Secretary's recognition of the problem of valuing gas for royalty purposes in these unusual times of marketing conditions; and we welcome the amendment to NTL-5 which will permit a more reasonable framework for valuing royalty.

We remain concerned, however, as to the approximately 3-year period prior to August 1, 1986. As noted in last week's meeting of the Mineral Management Service Advisory Committee to the Secretary, some severe hardship cases exist if the NTL-5 provisions are enforced during this 3-year period.

Although the example discussed at the Committee's meeting last week is for an extreme case, the burden nevertheless can be untenable for other situations.

The example referred to is for an NGPA category 107 well whose gas is being sold to the spot market at current spot market prices. For the San Juan Basin area this spot market price is currently $1.09 per MMBTU without reimbursement for taxes. At the same time, the NGPA ceiling price for 107 category gas is $6.23 per MMBTU.

Under NTL-5, for this example, the royalty for a 1/6 lease would be $1.038 and the producer's gross income would be $1.09 per MMBTU. This constitutes an excessive effective royalty rate approaching 100% of the producer's income.

...

BENSON-MONTIN-GREER DRILLING CORP.

When we inquired as to the Department's position with respect to this obvious inequity, the reply as I understood it was that the states and Indian Tribes were concerned that if the amendments to NTL-5 were made retroactive that they would have to return royalties already received; and that their current budgeting constraints would result in hardship to the states and Tribes.

In this respect, I believe the states and Tribes are mistaken. Industry has generally been under the impression that the Department of the Interior would not require that royalty be valued at a price in excess of that which the producer is receiving (and this principle has been introduced by the Department in the current ongoing studies regarding the proper method to value oil, gas and coal for royalty purposes). In view of this, I believe you will find that very few companies have been paying royalties based on the NGPA ceiling prices; and that accordingly the states and Tribes will not have to refund royalties already received. Rather what will happen if NTL-5 is enforced is that companies will have to pay <u>additional</u> amounts above that already paid.

You noted at the meeting that the Secretary was concerned about issuing an order which would be retroactive; and that if relief is to be granted that it might have to come about by a different method. Presumably one method would be by companies bringing suit against the Department; but I am wondering now if perhaps legislation might be a better route; so by copy of this letter to Senator Domenici, I am asking for his views in this respect.

If I can be of any further help in trying to resolve this issue, please don't hesitate to contact me.

Yours truly,

Albert R. Greer

ARG/tlp

cc: Senator Pete V. Domenici

Files: 815-E
816-F.1

bcc: Tom Dugan
Alvin Baca
George Yates
Peyton Yates
Bob Bayless
Greg Merrion

TEMAGAMI OIL & GAS INC.
P.O. BOX 48
ROYAL BANK PLAZA,
SUITE 3906, SOUTH TOWER TORONTO, ONTARIO, CANADA TELEPHONE: 416/865-1991
M5J 2K2

October 1, 1986

Mr. Kenneth M. Moyers, Chief
Royalty Compliance Division
Minerals Management Service
United States Department of the Interior
P.O. Box 25165, Mail Stop 655
Denver, Colorado 80225

Gentlemen:

Temagami Oil & Gas Inc. ("Temagami") hereby formally appeals, in accordance with the provisions of 30 CFR 290, against the assessment for unpaid royalties deemed due to the Minerals Management Service ("MMS") for natural gas produced from Federal Lease Nos. 49-060947 and 49-060494 (the "Leases") for the period August 1980 through December 1985 in the amount of $94,471.14 in accordance with your letter dated September 2, 1986. Said letter was received by us, Registered Mail, on September 9, 1986.

Temagami agrees that there are some unpaid royalties due the MMS but is not in agreement with the amount of such unpaid royalties as assessed by the MMS. There are two areas of disagreement:

1. Points of fact concerning quantities of gas sold and monies already paid.

2. Matters of interpretation pertaining to the value of production for the purpose of computing royalty as provided for in 30 CFR 206.103.

As background for our appeal, it is necessary to review some history of gas production in this area of Wyoming. In a memo of March 1978, the District Engineer of the USGS in Thermopolis wrote to the District Manager concerning "gas flaring in oil fields west and south of Worland" and noted that "because of the large distance involved between wells and the enormous amount of gathering line, as well as the compressors needed, it is not economically feasible, considering the low volume of gas involved, to require that this gas be reinjected. The fields in this area have a history of very rapid decrease of fluid and gas production". He goes on to say that "the same problems exist when one considers a gas sweetening plant". The memo also points out

that "the gas contains hydrogen sulfide". The problem of how to dispose of the gas is obviously not new. The United States Department of the Interior certainly has been well aware, for several years, that the gas, as produced, was not saleable.

The Leases do not now produce, and have never produced, natural gas in a form which is saleable to any potential purchaser in the area. All gas, which was produced in association with crude oil, contained varying percentages of H_2S and CO_2. Such acid gas content of the produced gas was many times in excess of the maximum levels that could be accepted by pipeline companies and/or the marketplace. Pressure was brought to bear, in late 1980 and early 1981, on companies producing in this area to do something with the gas being flared to, among other things, reduce the level of H_2S emissions. There was, however, insufficient gas available in this area to support, either technically or economically, the construction of a processing plant to clean up the produced gas so that it could be sold (See Annex "A"). By mid 1981, sufficient wells had been completed in the area, or were proposed for drilling, so that a gas plant was considered marginally feasible (See Annex "B").

A decision was made, therefore, to build a plant capable of handling 2.2 MMCF of produced gas containing about 2.3% acid gas. There were inadequate quantities of gas available from the Leases alone, so it was necessary to purchase gas from many surrounding wells owned by other producers in order to justify the construction of the plant. This was not only an economic problem but also a technical one. The total produced gas from the Leases alone was insufficient to provide adequate gas flow velocities to allow the plant to operate technically.

Construction began on the gas plant prior to having contracted for a sufficient quantity of produced gas containing low enough quantities of acid gas to meet the plant's requirements. The plant, costing in the order to $2.0 million, was constructed and physically completed late in the third quarter of 1981. By that time, it was determined that many of the wells in the area did not produce enough gas to even pay for the costs of constructing the gathering lines from such wells to the gas plant, therefore, the quantity of gas available was well below what was required. It further turned out that the majority of the gas available had acid gas contents many times the design level for the gas plant. For example, acid gas contents of up to 28.1% versus the 2.3% design level, were being encountered. The gas plant was technically incapable of processing gas of such high acid gas contents, but it was impossible to reject these gas feeds since the total gas

available to the plant was then only about 1/3 of the design level, which was nearly too low to allow the plant to technically operate at all.

Major modifications were made to the gas plant over several months in an attempt to get it to operate on the high acid gas levels. Production of saleable gas did not begin until Dec.1981 with all such gas, being delivered to MDU, the only prospective purchaser in the area under an agreement entered into in January, 1982. However, it was only possible to operate the plant intermittently with extensive shutdowns for technical reasons. Produced gas feed to the gas plant came not only from the Leases but also from a number of other producers in the area. In fact, the majority of the gas processed came from others.

The gas plant was operated for a little over two and one half years without ever having made a profit, let alone recovering the investment. Gas volumes were declining as oil production declined. MDU had been taking only a portion of the gas being offered to it since February 1, 1983, and by late 1984, was reducing prices drastically. The owners of the gas plant were coming under increasing pressure from the Wyoming Air Quality Control Authorities to make major capital additions to try to reduce the sulphur emissions. By the latter part of 1984, the gas plant was shut down completely due to the inability to resolve the environmental problems.

On December 28, 1984, the gas plant, with the concurrence of the Wyoming Air Quality Control Authorities, was sold to Spectrum Energy, Inc. of Billings, Montana ("Spectrum"). As part of the sale of the gas plant, Temagami undertook to deliver to Spectrum all of its share of produced gas from any wells in the area at the maximum price that Spectrum paid to third parties for the purchase of similar gas. A copy of this contract with Spectrum is on file with the BLM in Worland (Also see Annex "H").

Spectrum reportedly spent a further $500,000 on modifications to the gas plant and reached agreement with the Wyoming Air Quality Control Authorities for revisions in the Operating Permit for the plant. Spectrum has been purchasing the produced gas from the Leases since January 1, 1985, and has been paying Temagami the maximum price that it has been paying to any other of its suppliers of produced gas.

At the time when Spectrum purchased the gas plant, they were faced with the necessity to spend in the order of $500,000 to modify the plant to meet the requirements of the Wyoming Air Quality Control Authorities. They were also faced with difficulties in selling, at any price, the sweet gas after processing, and certainly could not sell the gas at anything approaching the "ceiling price".

The holders of the Leases entered into a contract with Spectrum to sell all of their produced gas to the plant then owned by Spectrum. You are referred to Clause 501 of the contract attached hereto as Annex "H", wherein Spectrum agrees to purchase the produced gas at a price of $0.20 per MCF of produced gas less the acid gas content. This clause goes on to provide that the Seller of the gas would receive 70% of any amount over $2.50 per MCF that Spectrum would ultimately receive for the sale of any gas which had been processed at the plant. Spectrum, to this date, has not been able to sell any gas at a price in excess of $2.50 per MCF.

Under the agreement whereby Spectrum purchased the gas plant, Spectrum confirmed that the gas purchase contracts to be entered into with the holders of the Leases would be modified and amended, as required, "to be no less favourable to Sellers than other contracts entered into from time to time by Purchaser for the supply of Natural Gas to the Property". As a result of this clause, Spectrum increased the price that they paid for gas from the Leases from $0.20 per MCF to $0.40 per MCF effective May 1, 1985. This is the price received by the holders of the Leases to this date.

There is no question that the agreement with Spectrum is an arm's-length transaction. There is no question that the price received by the holders of the Leases for the produced gas is the "highest price paid or offered for a majority of like-quality gas produced in the field or area". There is no question that the sale of gas to Spectrum constitutes Intrastate sales and not Interstate sales so there is no question that ceiling prices do not apply. It follows, therefore, that the valuation of produced gas for the purpose of calculating royalty cannot be anything but the price actually received by the holders of the Leases. The royalties, as assessed by the MMS, are greater even than the gross proceeds received by the holders of the Leases from the sale of the gas for the period from January 1, 1985 to date.

The assessment letter from the MMS dated September 2, 1985, quotes in part 30 CFR 206.103. It stops before quoting the key part of this section of the Oil and Gas Operating Regulations. The section quoted goes on to say:

> "In the absence of good reason to the contrary, value computed on the basis of the highest price per barrel, thousand cubic feet, or gallon paid or offered at the time of production in a fair and open market for the major portion of like-quality oil, gas, or other products produced and sold from the field or area where the leased lands are situated will be considered to be a reasonable value".

Attention is drawn to key aspects of the above paragraph. "Likequality gas" and "produced and sold from the field or area where the leased lands are situated" are key phrases. You do not compare apples and oranges. Sour gas as produced is not the same as marketable sweet gas which is subject to a ceiling price. There is no "good reason to the contrary" to use any value other than the "highest price per...thousand cubic feet... paid or offered at the time of production in a fair and open market for the major portion of like-quality...gas...produced or sold from the field or area where the leased lands are situated".

In summary, the only value which can be applied to sales of produced gas from the Leases is the valuation actually paid to the holders of the Leases. Any other valuation would constitute a demand for royalty on a valuation in excess of reasonable market valuation and would be, therefore, unlawful, confiscatory and violative of the Fifth Amendment.

Royalties have been paid in accordance with this value for the period from January 1, 1984 to April 30, 1986. Payment for royalties calculated on the same basis for the period from start of sales of produced gas to December 31, 1984 in the amount of $5,041.25 has been sent separately. There are no other royalties payable in accordance with the Statute and the Leases themselves, on gas produced from the Leases. A tabulation showing the corrected assessment is attached hereto as Annex "N" showing unpaid royalties as zero. A copy of the payment of $5,041.25 is attached as Annex "O".

We respectfully request you to revise your assessment to reflect the above and to show that all royalty payments have been fully and correctly made.

Yours very truly,

Donald C. Campbell,
President

DCC:bvg
Attachments

United States Department of the Interior
MINERALS MANAGEMENT SERVICE
ROYALTY MANAGEMENT PROGRAM
ROYALTY COMPLIANCE DIVISION
P.O. BOX 25165
DENVER, COLORADO 80225

IN REPLY REFER TO:
MMS/RCD/OSTPS 6-8-31
MS 655

SEP 2 1986

REGISTERED MAIL
RETURN RECEIPT REQUESTED

Temagami Oil and Gas, Limited
2300, 300 5th Avenue S.W.
Calgary, Alberta, Canada T2P 0L3

Gentlemen:

The Wyoming State Auditor's Office (State), in accordance with Section 205 of the Federal Oil and Gas Royalty Management Act of 1982 (FOGRMA), has reviewed Temagami Oil and Gas, Limited's (Temagami) production and sales records for natural gas produced from Federal Lease Nos. 49-060947 and 49-060494, for the period August 1980 through December 1985. The review shows that Temagami underpaid royalties due the Minerals Management Service (MMS) by $94,471.14. This letter addresses Temagami's nonpayment of royalties due on the referenced leases. Additional audit issues described in the State's issue letter of April 15, 1986, will be addressed separately in future correspondence.

Federal lease terms, regulations and instructions establish monthly payment requirements, along with the value to be used in calculating royalties due on the referenced leases. Contained within Section 2 of the Federal Lease, entitled "The Lessee Agrees", are terms requiring the payment of royalty which state in part:

> "(d)(1) To pay the lessor 12 1/2 percent royalty on the production removed or sold from the leased lands computed in accordance with the Oil and Gas Operating Regulations (30 CFR Pt. 221)."

Concerning royalty value, Title 30 of the Code of Federal Regulations (CFR), Section 206.103 states in part:

> "The value of production, for the purpose of computing royalty, shall be the estimated reasonable value of the product as determined by the Associate Director due

MMS

MINERALS MANAGEMENT SERVICE
U.S. DEPARTMENT OF THE INTERIOR

STATEMENT BY BILL BETTENBERG, DIRECTOR OF MINERALS MANAGEMENT SERVICE
IN RESPONSE TO CONGRESSIONAL COMMITTEE REPORT ON ROYALTY MANAGEMENT PROGRAM

October 1, 1986

Every program can be improved, and we welcome constructive criticism and proposals. It is unfortunate that this report, which has some good information in it, is flawed with so much invalid information and so many erroneous conclusions.

The Minerals Management Service has an aggressive program to collect mineral royalties due and to discover and recover underpayments of royalties.

Material in the congressional report implies that royalty underpayments may be as high as 21 percent. The report's approach, however, is seriously flawed in that it:

1) is based on an unrepresentative sample of audit findings,

2) excludes audit findings that detected overpayments or no problems, and

3) includes complex findings that are on appeal or in litigation and may be decided in favor of the payor.

Rather than 21 percent underpayment as the report estimates, our staff estimates that the rate is more likely around 3 percent. The Department's Inspector General plans to study that this fiscal year. More importantly, our program expects some underpayment. Just as an individual may interpret the tax code to his own advantage and then have to justify it to the IRS, or make a reporting on computational error, we know that there will be some disagreement between individual companies and the MMS over the amount of royalties due to the government.

That is why we have an aggressive auditing program, and it is why we pursue thousands of collection actions.

We have collected or denied refunds totalling about $110 million through our audit effort during the first 11 months of Fiscal Year '86. This includes amounts found through MMS staff audits, Inspector General "Lookback" audits, and audits conducted by nine states and tribes under agreements with us. We have collected about $20 million more in late

(more)

payment interest, underreporting of production, and liquidated damages for late and erroneous reporting.

After some study, we believe that with additional auditors we may be able to collect in the neighborhood of $20 million more in underpayments a year and have worked with Congress to obtain funding for that effort.

We have been working virtually around the clock this past week to analyze and respond to the Committee report. We regret that the authors chose not to wait for our comments before releasing their document.

Generally, the problems are these:

-- The report has lots of errors and we haven't been able to verify much of their data;

-- Their estimate of underpayments is skewed because they are based largely on our audits which were targeted on obvious major underpayments, leaving out cases where little or no underpayment was found, and not considering the cases where overpayments occurred;

-- They ignored the fact that many valuation cases are in the courts where it may be determined that companies owe the federal government nothing,

-- It virtually ignores the many positive elements of the program and the tremendous progress made over the past several years.

###

THE STATE OF WYOMING

Wyoming State Auditor

STATE CAPITOL BUILDING CHEYENNE, WYOMING 82002

JACK SIDI
STATE AUDITOR

(307) 777-7831

TOM JONES
DEPUTY STATE AUDITOR

March 19, 1987

Mr. Dennis Whitcomb
Minerals Management Service
P.O. Box 25165
DFC, Mail Stop 651
Denver, CO 80225

Dear Mr. Whitcomb:

Although the Wyoming State Auditor's Office has previously commented on the proposed retroactive cancellation of NTL-5, we offer additional comments, especially on the financial impact of the proposed cancellation.

An important consideration in any rule-making is the degree of reliance which can be placed on those rules. Lessees and payors must strictly comply with the MMS regulations when determining value. State, tribal, and MMS auditors must also adhere to these same rules and regulations in their compliance and enforcement activities. It is impossible for auditors to function as an effective compliance and enforcement tool if they cannot rely on the Secretary to stand behind his own regulations. Lessees can never be certain that their royalty payment obligations are satisfied if the valuation rules are subject to retroactive change.

Should NTL-5 be rescinded retroactively, the regulations in 30 CFR 206 would be the only remaining valuation standard. The majority pricing analysis required by the MMS interpretation of Section 206.103 is unworkable from a payor's standpoint because of the time and effort required to collect the pricing data and perform the calculations.

Should the MMS persist in its efforts to cancel NTL-5, the MMS should consider using the NGPA decontrol dates as the NTL-5 rescission dates, rather than the arbitrary dates proposed in the cancellation notice. Our audits have shown many instances where market-out dates and prices in Wyoming have been affected by negotiations on contracts in other states. In other situations, take-or-pay liabilities have been a controlling factor in redetermination of gas sales prices under market-out clauses.

The MMS has stated that although the retroactive cancellation of NTL-5 may result in some reduction in royalty value, the amount will not be significant. With this statement, the MMS admits it has never enforced the provisions of NTL-5. Had it done so, the effect would most certainly be significant.

Using 1985 production figures, we estimated the potential loss of revenue due to the MMS's inability to enforce NTL-5. In 1985, there were 291 federal wells in Wyoming classified in NGPA Category 107(c)(5). Approximately 24 million MCF were produced from these wells during 1985. The average 107(c)(5) ceiling price during the year was $6.014. Purchases by major pipelines were determined as well as the average market-out price for each of those pipelines. The difference between the average ceiling price of $6.014 and the average market-out price for each pipeline was multiplied by the pipeline's purchases. These amounts were then summed and multiplied by 12.5% to estimate uncollected royalties on 107(c)(5) gas in Wyoming during 1985 as a result of failure to enforce NTL-5. This amounted to over $6.6 million as shown below:

PURCHASER	AVERAGE 107(C)(5) PRICE	AVERAGE MARKET-OUT PRICE	PRICE DIFFERENCE	1985 PURCHASES (MCF)	VALUE DIFFERENCE
A	$6.014	$4.50	$1.514	6,418,894	$ 9,718,205
B	"	$3.19	$2.824	3,352,124	9,466,398
C	"	$2.40	$3.614	382,884	1,383,743
D	"	$3.30	$2.714	5,263,879	14,286,168
E	"	$3.50	$2.514	980,935	2,466,070
F	"	$2.75	$3.264	245,195	800,316
G	"	$4.00	$2.014	174,959	352,367
H	"	$4.00	$2.014	7,176,791	14,454,057
				23,995,661	$52,927,324

$52,927,324	Value Difference
x .125	Royalty Rate
$ 6,615,916	Uncollected Royalties

Further, we estimate that 40% of the volumes shown above were transferred under non-arm's-length conditions.

A similar procedure was used to estimate the impact of failure to enforce NTL-5 for NGPA Category 102 wells. There were 980 federal wells in this category in 1985, with total production of approximately 96 million MCF. The average 102 ceiling price during 1985 was $4.00. The average market-out price was $3.00, yielding a $1.00 average price differential between 102 ceiling prices and 102 market-out prices. Multiplying the 1985 production by the $1.00 differential and the royalty rate yields an estimated royalty loss for 1985 on Section 102 gas of just under $12 million.

95,962,587 MCF x $1.00 x .125 = $11,995,323

Information for these estimates was taken from the Petroleum Information Production Report for 1985 and the FERC filings maintained by the Bureau of Land Management.

Combining the estimates for the 107(c)(5) and the 102 gas yields a total estimated loss for 1985 for these two categories of $18,611,239.

$ 6,615,916	107(c)(5)
11,995,323	102
$18,611,239	Total

Considering that the $18.6 million is an estimate for 107(c)(5) and 102 gas produced in 1985 in Wyoming only, the total losses nationwide over the effective period of NTL-5 are enormous.

In summary, the proposed cancellation of NTL-5 is an admission of the MMS's inability to enforce its own rules and regulations. The effect of the cancellation will be to legitimize by rule cancellation the payment practices of the industry. Payors and auditors alike will be forced to operate with the knowledge that the MMS cannot be trusted to stand behind its own rules and regulations.

Sincerely,

Jack Sidi

SLB/tat

FAMS COPY

WALTER S. FEES, JR.
OIL & GAS OPERATOR

2516 Foresight Circle
Room 10
Phone 242-2044
Grand Junction, Colorado 81505

June 30, 1987

The Honorable

Dear

This letter is with regard to a request by certain Indian Tribes and State Governments to get Congress involved in the determination of Oil and Gas royalty valuation on oil and gas production from Federal lands.

The Minerals Management Service (the responsible department) of the Interior Department has proposed a valuation standard based on an arms-length contract price between the producers and the purchasers. This has been the historical method of determining royalty valuation since the beginning of the oil and gas industry. However since Congress enacted the N.G.P.A. of 1978 the spread in the price of gas between prices under old contracts and new contracts has caused people outside the industry (including federal & state auditors) to wonder why all gas should not be valued the same. This would be nice for the royalty owners. It would be chaotic for the gas consumer, State Utility Commissions and to the gas producers. The royalty recipients are only concerned about royalty gas, not the producers and consumers gas. They do not understand that under the normal twenty (20) years gas contract the gas pipeline purchasers will "NOT", and are not obligated under law to, alter the contract, therefore the producer is bound by the contract to take the "arms-length" price for gas produced and thus they have paid royalty on that price. Below is an example of what could happen if the royalty price did not follow the contract price.

In September of 1985 a government auditor examined our books and gas purchase contracts. One of the contracts he checked was signed with the purchaser in 1966, the original price for gas under this contract was thirteen (.13¢) cents per thousand cubic feet (MCF), eventually the price escalated until in 1985 it had risen to thirty cents (.30¢) per thousand cubic feet (MCF). The auditor contended that under the Natural Gas Act of 1978 the price for royalty gas since 1978 should have been $4.11 per MCF, a difference of $3.81/MCF. Under

WALTER S. FEES, JR.
OIL & GAS OPERATOR

2516 Foresight Circle
Room 10
Phone 242-2044
Grand Junction, Colorado 81505

the terms of the contract the purchaser would not even consider paying this higher price, thus the auditor claims the producer is liable for royalties twelve times the amount paid under the terms of the 1966 contract. Actually the royalty as calculated by the auditor was 150% of the total value received by the producer for 100% of the gas produced. By 1988 the interest alone charged by the government on what is allegedly owed could be more than what the auditor said was deficient. This 1966 contract was audited previously in February of 1983 by the Minerals Management Service and the royalty value was established on the basis of what the arms-length contract called for (see enclosed letter).

This auditor's interpretation is currently under appeal and a settlement had seemed probable with the announcement by the Minerals Management Service of their approval of arms-length contracts. However if Congress intervenes in this problem and no resolution is made for a year or two there will be real problems for producers.

With the Energy Industry, particularly the independent operators already in a disasterous depression, a policy which would force the producer to pay more to the royalty owner than he is receiving for the sale of 100% of the gas would automatically and immediately cause the abandonment of all wells that are affected. With the Country nearly forty percent (40%) dependent on foreign oil a royalty policy that would further drive people from the Energy industry and would force abandonment of more wells would be devastating for national security and would result in less royalty money from Federal lands for the Federal and State governments and the Indians.

As a legislator would you please vote to return this problem to the jurisdiction of the Department of the Interior.

Yours very truly,

Walter S. Fees, Jr.

WSF/mm

Enclosure

United States Department of the Interior
OFFICE OF THE SECRETARY
MINERALS MANAGEMENT SERVICE
ROYALTY MANAGEMENT PROGRAM
P.O. BOX 2853
CASPER, WYOMING 82602

IN REPLY REFER TO:

TCS/1401

April 7, 1983

CERTIFIED MAIL
RETURN RECEIPT REQUESTED

Mr. Walter Fees, Jr.
2516 Foresight Circle, Room 10
Grand Junction, Colorado 81501

Re: 91-001677
Hunters Canyon Unit

Dear Mr. Fees:

In regards to your letter dated March 28, 1983, NTL-5 (Notice to Lessees and Operators of Federal and Indian Onshore Oil and Gas Leases) states in part:

> II. Intrastate and Other Sales or Dispositions Not Subject to Price Jurisdiction of the FPC
>
> A. Establishment of Royalty Values
>
> 1. For sales from wells commenced prior to June 1, 1977, and which are subject to an arm's-length contract entered into prior to that date, the base value for royalty purposes shall be established as the higher of:
>
> a. The price received by the lessee or operator in accordance with the provisions of the applicable sales contract, or
>
> b. A minimum value of not less the 18 cents per MCF of 14.73 psia and 60°F. (Emphasis added.)

Thus, we still need the applicable amended reports and payments to reflect the 18 cents per MCF minimum price before adjustment.

Also, Hunter-Fee Well No. 6 received Section 109 pricing for the initial months of sales then started receiving Section 102 pricing. Hunter-Fee Well No. 7 received Section 109 pricing for the initial months of sales then began receiving Section 103 pricing. A well that qualifies for Section 102 or 103 pricing could have always qualified for Section 102 or 103 pricing from the date of the first sales. Royalties must be paid on the highest price legally obtainable, and failure to file for a higher price is not a valid reply. Thus, amended reports and payments are required to reflect the higher prices.

The materials requested above must be received by April 21, 1983, and should be sent to the following address:

Mr. Tom Struyk
Joint Federal/Colorado Audit
Minerals Management Service
P.O. Box 2859
Casper, Wyoming 82602

If you have any questions, feel free to contact Mr. Tom Struyk at (307) 261-5390.

Sincerely yours,

James P. Morris
Chief, Casper Royalty Compliance Office

Senator MELCHER. Well, the sum and substance of your position is that no producer should be required to pay royalties computed on the basis of a higher price than he actually received for the sale of the gas.

Mr. WILSON. That is absolutely correct.

Senator MELCHER. I think that is what the law is, but there are some people determined that that isn't what the law is. And I would want to make sure that we did the right thing and reestablish the law as being that case.

It has puzzled me, since all leases that I am familiar with are computed on that basis, why we ever got led astray to where some people, either the Department or the tribes, were invited to think that there could be something other than a basis for royalty. Is there something in the law that says that the lease is not the legal document on which you base royalties?

Mr. WILSON. That is certainly our opinion that the lease terms, as they stand, whether on Federal or Indian acreage, are what should be determinative.

Senator MELCHER. And aren't all leases based on market price for the product?

Mr. WILSON. Generally that is up to the interpretation of the parties. But in most cases that is certainly the interpretation. Now, there are some differences on Indian leases where it talks about different tests, but generally it is market-based.

I think that we were very surprised after the MMS had taken a market—was indicating that they were taking a market-based approach as producers contacted them in this process, and producers were very surprised when they began getting invoices based on NGPA ceiling prices, frankly, under auditors interpreting NTL–5, which should have been changed by the administration, by Interior, after the Natural Gas Policy Act was passed. It is unfortunate that that notice sat there unchanged for the period that it has.

Senator MELCHER. Well, Mr. Wilson, there may be additional questions for the record coming from other members or from myself. And for that purpose I am announcing now that the hearing record will remain open for 2 weeks both for purposes of anybody submitting written testimony for this hearing in addition to what has been given here this morning, or for the second purpose, for myself or others on the subcommittee asking additional questions and asking for a response. And we would like to have those responses within 2 weeks.

Mr. WILSON. We would be happy to respond.

Senator MELCHER. All right. Thank you very much.

Mr. David Burnett, Chandler & Associates from Denver, Colorado. Mr. Burnett.

STATEMENT OF DAVID BURNETT, ON BEHALF OF CHANDLER & ASSOCIATES, INC., DENVER, CO

Mr. BURNETT. First of all, I want to thank the Chairman for giving us this opportunity to speak, and I share your concern and puzzlement and amazement that we are even here today to debate whether it is reasonable for a producer to have to pay royalty

based on a price that is clearly unattainable and has been since 1982. And I appreciate your leadership role.

I also appreciate Senator Wirth and his efforts in this, and a special thanks to Senator Nickles for leading the fight in the Appropriations Committee. I mean, let's be frank. Oklahoma's liability isn't all that big, but Senator Nickles and others saw that this was fundamentally wrong and did something about it.

I am here on behalf of Chandler & Associates. Chandler is an independent from Colorado, and he has been producing on Federal lands for over 30 years. My specific role since 1980 with respect to this has been to market the gas, negotiate Chandler's contracts and also to work with the MMS on various royalty matters, including NTL–5. I should say that I am not an attorney, nor am I a representative of any group. I am here on behalf only of one producer. And I will give you one producer's perception of what has happened.

I think there are two basic points that I want to make from this statement, the written statement that I have provided you. Number one, as far as I am concerned, in dealing with the MMS in the field in Lakewood, Colorado, the MMS' historical position has been that royalties should be based on what producers actually receive and not on an outdated NGPA ceiling price. So, as far as I'm concerned, this process is merely a method of formalizing what has been the historical trend with respect to MMS.

It kind of concerns me that we talk about retroactive because that implies that we have been in one direction and we are shifting. That hasn't been the case out in the field. The reality is that every time that I was confronted with a price reduction where a pipeline company in the real world said you either reduce your price now or your wells are going to be permanently disconnected because that was the way the contract was written with respect to Chandler & Associates.

Before we agreed to price reduction, we knew this problem existed. We went to the MMS in Lakewood and we confronted them with our dilemma. What do we do? Every time until 1985 the MMS said regulations affecting NTL–5, regulations that will make clear that arm's length contracts should rule the day, are forthcoming, and they advised us to pay based on what we received. There are plenty of letters. There is plenty of verbal communications speaking to this point.

So, I think that's the number one thing. This is something that we have been grappling with—MMS and producers—since 1982 and 1983. And to go back now, particularly on independents who are struggling with dramatic price reductions, and say, no, we told you this once, we're saying now that this isn't the way we want to proceed, is going to put a lot of independents into bankruptcy frankly.

The other thing. I'm going to be real brief here. There are two misconceptions or two questions that I think need to be addressed. One is what I call the litigation issue, and that is there has been talk that if you do not change NTL–5, do not modify it, let the state and Federal auditors come in, audit, and it will be litigated in court after all, so let's not worry about it. The fact is that with re-

spect to independents—and I'll give you, as I understand, the process that it would go through.

If NTL–5 is not modified, the auditors would come to Chandler & Associates and they would say, this is your liability. And by the way, Chandler & Associates has always been up front in the statements telling people, everyone who would listen, exactly how we proceeded.

This is your liability, and this is what we are going to assess. So, the producer would have to go back to the MMS and either post a bond or provide money to take care of that. The problem is that independents—and they will testify to this.

I don't talk just about Chandler. I talk about all independents—it is almost impossible to get bonds. So, what you are talking about is up front giving that money and then proceeding with thousands of dollars of litigation costs. And that just doesn't seem reasonable.

The other issue that I wanted to talk to you about quickly is the whole issue of—you know, there's a perception that NTL–5 if retroactive—this whole business. And I wanted to present another wrinkle in this that I think is important to realize, and that is independents get their financing from two basic sources, particularly smaller ones. Number one is from the banks through debt financing, and the other is through partners. In the case of Chandler & Associates, his partners have been with him for years and years and years.

Now, if we were to go back to his partners and say, well, even though the MMS told us this, they have reversed this, we owe this, those partners are going to say—if they agree to pay, they are going to say fine, but don't come to us for further financing anymore.

The other issue is banks. The banks, particularly smaller banks who have lended to smaller independents in these areas are at risk. Their loan portfolios are at risk. And once again, they will testify to the fact that it is very difficult, if not impossible, now for independents, even independents that have been around for a long time, to receive financing from banks. So, this has an implication for the future, not just for the past. And I think that is very important that we look at that.

And let me just say one other thing and that is, as I was looking at who are constituencies that are going to be impacted, obviously independents—all producers, but in particular independents, banks, finance.

But another constituency group that has not been talked about much that will be affected by this are the end-use gas customers because in a substantial amount of contracts—unfortunately not Chandler's, but in others—there are excess royalty clauses. And those excess royalty clauses say that if there is a royalty charged in excess of what the royalty was when the contract was executed, that the pipeline company will have to pay that. What the pipeline company will do right then is they will pass it on to the rate-based customers. So, the net effect will be that industrial end users, consumers, will have increased cost as a result of NTL–5.

And that is why the FERC, the general counsel of the FERC—that is one of the reasons why they testified or they wrote comments in favor of retroactive modification of NTL–5.

I think my written statement is pretty self-explanatory, and if there are any other questions, I will be glad to entertain them.

[The prepared statement of Mr. Burnett follows:]

Testimony Of David Burnett On Behalf Of Chandler Associates, Inc.

Subcommittee On Mineral Resources Development And Production

Hearings On Notice To Lessees-5 July 10, 1987

Good morning. My name is David Burnett. I am appearing on behalf of Chandler & Associates, Inc. ("Chandler"). Chandler, an independent oil and gas producer from Colorado, has been producing natural gas and oil from federal lands for over thirty years.

Since 1980, I have marketed Chandler's gas, negotiated its gas purchase contracts, and worked with the Minerals Management Service (MMS) on various royalty matters, including NTL-5. So my knowledge of the gas markets in the Rocky Mountain area, as well as MMS' historical position on NTL-5, comes from first hand knowledge.

Accordingly, I welcome the opportunity to provide this Subcommittee with a "real world" discussion of the impact of NTL-5 on one company. Simply stated, Chandler will be badly hurt absent a modification of NTL-5 which clearly states that contract proceeds shall be the basis for determining royalties.

As I will discuss later in this statement, such a modification would not be a sudden shift in MMS policy. Indeed, the MMS, both verbally and in writing, has advised producers to pay royalties based on contract proceeds since 1983, when

slumping gas prices dropped below the maximum NGPA ceiling prices for certain categories of gas.

It is worth noting that Chandler's situation is not unique; there are other independents in greater danger of total collapse if NTL-5 is not modified. All producers, but particularly independents, have been devastated by dramatic reductions in natural gas prices. In one area, for example, for Chandler prices have dropped from a high of $5.15/MMBTU in March of 1983 to a low of about $1.00/MMBTU in December of 1986.

When purchasers imposed price reductions during the 1982 to 1986 period, producers consulted the MMS for advice on how to determine federal royalties. In every instance I am aware of, the MMS advised producers to pay royalties based on what they received pursuant to their arm's length contract, not on artificially high NGPA ceiling price. To go back now and impose a terribly outdated royalty regulation on an already ravaged independent sector will push many good companies into bankruptcy.

I cannot believe that this is what the MMS intended when it first promulgated NTL-5 in 1977.

In order to give the Subcommittee a better understanding of market conditions over the last four years, permit me to briefly describe Chandler's specific experience in one gas field: the Piceance Basin of Northwest Colorado. This is a so-called "tight

sands" gas area and is a difficult and relatively expensive area in which to drill and produce. Indeed, it was only after Congress authorized incentives under the Natural Gas Policy Act of 1978 that producers like Chandler began to aggressively explore in the area.

Until early 1983, the contract price equalled the NGPA ceiling price for section 107 tight sands gas. Accordingly, royalties were paid based on NTL-5 regulations. On February 22, 1983, however, the purchaser, Northwest Pipeline, sent Chandler a letter announcing that the price of its section 107 gas would be reduced. The alternative would be to shut-in the gas, or worse, permanently disconnect Chandler's wells.

We attempted to find another purchaser and contemplated legal action against the purchaser. Neither strategy proved practicable. Chandler could not afford an extended shut-in period caused by years of litigation and no other pipeline company in the area was interested in purchasing Chandler's gas at the maximum section 107 rate.

At the same time, we recognized that reducing the price presented a potential royalty problem as a result of NTL-5. I related to an official of the MMS our situation and asked him for advice on how to proceed. This MMS official told me that new NTL-5 regulations reflecting recent market changes were

forthcoming and to pay royalties based on the price received pursuant to Chandler's arm's-length contract.

After extensive negotiations with the purchaser and a market study of the purchaser's end use market, which verified the purchaser's claim that its market share was shrinking due to fuel switching, Chandler agreed to reduce its price on a temporary basis to $4.40/MMBTU, effective April 1, 1983. The maximum NGPA ceiling price for section 107 gas in April of 1983 was about $5.15/MMBTU.

As the market for gas continued to deteriorate, and under similar threats of indefinite shut-ins or permanent disconnections, Chandler agreed to further reduce its price over the next few years so that by July of 1986, Chandler's price had dropped to $1.40/MMBTU. In contrast, the NGPA ceiling price for section 107 gas in July of 1986 had increased to $6.23/MMBTU.

Every time Chandler was confronted with a price reduction, I consulted with the MMS, and every time the MMS advised me to pay royalties based on what we received, not the NGPA ceiling price.

It is important to note that Chandler was not the only producer receiving this advice from MMS. Since 1983 producers have been told by MMS that its policy was to accept gross proceeds received under arm's-length contracts as the basis for

determining royalties. The arm's-length price received has also been accepted time after time in audit.

For example, in a letter to Phillips Petroleum Company, dated August 4, 1983, Robert Boldt, then Associate Director for Royalty Management, MMS, wrote the following:

> The Minerals Management Service (MMS) is now in the process of issuing regulations and product value guidance implementing a Secretarial decision concerning valuation for royalty calculation purposes, of natural gas sold under forms of an arm's-length contract.
>
> MMS will accept gross proceeds received under a properly negotiated arm's-length contract as the basis for calculating royalties or gas produced on Federal lands.
>
> The Payor's Handbook will be revised to reflect this new policy.

I am aware of additional letters and numerous verbal communications from MMS from January, 1983, forward. In every instance, MMS assured industry that it would be acceptable to base royalties on arm's-length price received. These various communications clearly reflect the intent of MMS over the last several years.

On January 15, 1987, MMS proposed to formalize its historical position on NTL-5, namely, that royalties be based on what a producer receives pursuant to its arm's-length contract. The MMS proposal received widespread industry support. Moreover, in its July 5, 1987 resolution the Western

Governors' Conference accepted the main elements included in the MMS proposal.

Chandler supports the MMS proposal of January 15, 1987, and urges Congress not to delay the implementation of the modified NTL-5 which is already long overdue. For many independents, this is no longer simply a matter of fairness or regulatory appropriateness-- it is quite literally a matter of survival.

Thank you.

Senator MELCHER. Well, do you think that what has been described as the position of the six western governors on NTL–5—what do you think of that? Is that all right with you?

Mr. BURNETT. I think that the governors—and I met with quite a few of the aides on this—governors' aides. I think that they have gone a long way towards resolving this. There are specific things that will have to be worked over time, but I would say there is no question that I am pleased that the governors have come out and supported—

Senator MELCHER. Well, their position is for MMS to look at each transaction and see if it was at arm's length. Is that what you are referring to?

Mr. BURNETT. Yes, yes.

Senator MELCHER. And that is satisfactory.

Mr. BURNETT. Yes.

Senator MELCHER. All right. What about Indian tribes or Indian allottees? Do you think they are different? Does Chandler have any?

Mr. BURNETT. No, sir. That is——

Senator MELCHER. Well, I'm not going to ask you then. If you don't have any, I'm not asking you to form an opinion.

If NTL–5 is not retroactively modified, is it fair for me to summarize your statement as, first of all, it would be outrageous chaos, and secondly, it would be totally unfair?

Mr. BURNETT. No question. No question about it.

Senator MELCHER. Does that summarize it?

Mr. BURNETT. Yes, sir.

Senator MELCHER. Thank you very much. I think hearing from an actual producer such as Chandler is very instructive to the committee.

Mr. Michael Neumann, Director, Gas Marketing, Cities Service from Tulsa? Are you here representing not only Cities Service but the American Petroleum Institute?

Mr. NEUMANN. Yes, sir, I am.

Senator MELCHER. All right. Thank you. Please proceed.

STATEMENT OF MICHAEL NEUMANN, DIRECTOR, NATURAL GAS MARKETING, CITIES SERVICE OIL & GAS CORP., ON BEHALF OF THE AMERICAN PETROLEUM INSTITUTE, ACCOMPANIED BY PATTY PATTON, LEGAL REPRESENTATIVE, CITIES SERVICE OIL & GAS CORP., AND DAVID DEALE, WASHINGTON OFFICE REPRESENTATIVE OF THE AMERICAN PETROLEUM INSTITUTE

Mr. NEUMANN. I am Michael Neumann. Seated with me on my right is Patty Patton from Cities' legal department, and on my left is Dave Deale from the American Petroleum Institute's Washington office. Today we are appearing on behalf of the American Petroleum Institute whose over 200 company members and 5,000 individual members represent all facets of the petroleum industry. Some of the other industry spokesmen who have spoken today are also members of the API. Our members account for the majority of the total oil and gas exploration and production activity on Federal and Indian lands, both offshore and onshore and, therefore, are directly affected by Federal royalty management policies.

We welcome this opportunity to address NTL–5.

Simply stated API believes that the MMS proposal to rescind NTL–5 along a schedule linked to the decline in gas prices long overdue, equitable and fully consistent with existing laws and regulations. I believe this parrots the discussions of most of the committee as well as the testimony presented to date.

I wish to have my written testimony entered in the record, and I merely wish to summarize it by hitting a couple of high points.

When NTL–5 was issued in May 1977, natural gas traded in the interstate market was trading at or very close to the maximum allowable prices which could be collected under FERC's regulatory control of gas prices provided by the Natural Gas Act of 1938. Hence, the NTL–5, which required that royalty be due on the greater of Federal ceiling prices or contract prices, actually forces the producer to amend his contract to obtain the highest allowable ceiling price or pay an additional out-of-pocket royalty expense.

This works great in an atmosphere of gas shortage where gas continues to trade at its ceiling prices. However, as all the discussion has come about, the effective implementation of the incentive prices provided under the Natural Gas Policy Act have created an oversupply of natural gas, a deterioration of market prices, and this accompanying problem that we are discussing today. We concur with you that it only seems reasonable to pay royalty on the basis of what the producer receives not of some artificial maximum lawful price which may not represent value.

Commendably the MMS has reconsidered its July 1986 decision and in 1987 proposed to rescind NTL–5 and revert to the generic valuation regulations along a schedule of dates approximating the dates of the earliest price reduction actions which occurred for various categories of gas.

API continues to endorse this approach with two suggestions. First, we believe that the proposed dates should be presumptive and that the reduction in prices should be treated on a case-by-case basis. We have not until this morning understood that the MMS' written regulations do provide on a case-by-case basis as Mr. Bettenberg advised us this morning. So, we commend that approach by the MMS.

Second, in applying the generic regulations wherever an arm's length contract exists, we believe the MMS should use contract proceeds as the value of production. And where no arm's length contract exists, proceeds from comparable sales should be utilized. These suggestions have been set forth in API's March 1987 detailed written comments on the pending MMS proposal and are similar to the comments submitted about MMS' generic valuation proposals for onshore and offshore gas which are also under consideration.

API's position is consistent with the position paper adopted at the western governors' conference. And their paper endorses MMS' proposal to offer relief from NTL–5 on case-by-case basis.

Whatever course the MMS takes on NTL–5, the essential requirement is that royalty be paid on the true value of production which is best reflected in what the producer actually receives. No other approach is fair.

Furthermore, the postponement of a rational ending of this valuation process creates further uncertainty in the oil and gas operat-

ing business. We foresee that this could cost drastic litigation effects, as Senator Nickles has pointed out, and definitely provide for less operations on Federal oil and gas leases which is going to defer the energy independents' initiatives of the country.

I would like to also comment on something I heard from Mr. Wilson's testimony where you, Senator Melcher, asked if the lease terms referred to proceeds received. And many of the API members operate under leases which refer to paying a fractional percentage of the reasonable value as determined by the Secretary and as determined by the Secretary in accordance with the Code of Federal Regulations, section something.

[The prepared statement of Mr. Neumann follows:]

Testimony
of
Michael Neumann
on behalf of
American Petroleum Institute
before
Subcommittee on Mineral Resources
Development and Production
Hearings on Notice to Lessees-5
Washington, D.C.

July 10, 1987

TESTIMONY OF MICHAEL NEUMANN

Good morning. My name is Michael Neumann. I am Director of Natural Gas Marketing for Cities Service Oil and Gas Corporation in Tulsa, Oklahoma. Today, I am appearing on behalf of the American Petroleum Institute whose over 200 company members and approximately 5000 individual members represent all facets of the petroleum industry. Our members account for the vast majority of total oil and gas exploration and production activity on Federal and Indian lands, both offshore and onshore, and, therefore, are directly affected by federal royalty management policies.

API welcomes this opportunity to address Notice to Lessees-5 (NTL-5). Simply stated, API believes the MMS proposal to rescind NTL-5 along a schedule linked to the decline in gas prices is long overdue, equitable, and fully consistent with existing laws and regulations.

When NTL-5 was originally issued in May 1977, the existing regulations for valuation of onshore gas already provided that the value of production for royalty purposes be the "estimated reasonable value of the product as determined by the supervisor." The regulations further specified that in estimating reasonable value the supervisor give due consideration to several factors: highest price paid for a part or for a majority of production of like quality in the same field, the price received by the lessee, posted prices, and other relevant matters.

In 1977 interstate gas prices were near ceiling prices set by the Federal Power Commission under the Natural Gas Act and were expected to stay high; contract prices for new intrastate gas were even higher. These features of the gas market led the Secretary to issue NTL-5 pursuant to the existing generic regulation, providing that the value of production would be federal ceiling prices or contract price, whichever was greater.

By 1982, however, the situation had changed dramatically. In 1978 Congress enacted the Natural Gas Policy Act which, among other things, established ceiling prices as incentives for development and production and extended federal jurisdiction to include intrastate as well as interstate gas. More significantly, gas supplies swelled and in 1982 gas prices began a precipitous decline which has continued through 1986.

One thing did not change, however, the underlying regulation for valuation of onshore gas. In 1982 -- and today -- the regulation for valuation of onshore gas prescribes that the value of production for royalty purposes be the "estimated reasonable value of the product." Whereas NTL-5 might arguably have yielded reasonable values in the 1977-1982 period, a period of supply shortage, NTL-5 yields patently unreasonable values in the 1982-1986 period. For example, in July 1986 the average spot market price in the Rocky Mountain Area for NGPA §107 gas (so-called "tight sands" gas) was $1.39 per MBTU whereas the NGPA ceiling price was $6.23 per MBTU. If NTL-5 were applied

literally in this case, the royalty would be $1.04 per MBTU, a result which represents a royalty rate of nearly 75% of proceeds when the statute prescribes 16 2/3% of the value of production.

Given this disparity between NTL-5 and the underlying regulations, the MMS recognized in early 1983 that NTL-5 needed to be abandoned. Over a period of time MMS so advised producers and by memorandum so advised state and Indian auditors as well. In July 1986, the MMS took an important first step by rescinding NTL-5 for production after August 1986. But the July 1986 MMS action did not solve the problem that had started to fester in the early 1980's and continued up until August 1986. During that period of low demand gas pipelines routinely exercised contractual provisions (so-called "market out" clauses) by which they offered producers various options, which reduced to their simplist terms gave a producer a simple choice: accept a lower price for the gas or shut in the well.

Commendably, however, the MMS has reconsidered its July 1986 decision and in January 1987 proposed to rescind NTL-5 and revert to the generic valuation regulations along a schedule of dates approximating the dates on which the earliest market outs occurred for various categories of gas. API continues to endorse this approach with two suggestions: First, the proposed dates should be presumptive dates. In this way a lessee who received a

price less than the NGPA ceiling price prior to the presumptive dates could still obtain relief if he provides competent evidence. Likewise, the presumptive dates would not apply if it could be shown that a lessee did not receive less than the NGPA ceiling price until a later date. Second, in applying the existing generic regulations, MMS should use contract proceeds as the value of production where an arm's-length contracts exists and comparable sales where no arm's-length contract exists. These suggestions are set forth in API's March 1987 detailed written comments on the pending MMS proposal.

Significantly, API's position on this issue is consistent with the resolution adopted at the July 5, 1987 meeting of the Western Governors' Conference. This resolution recognizes that in the 1982-1986 period producers often received prices well below NGPA ceiling prices. This resolution also endorses the MMS' proposal to offer relief from NTL-5, provided lessees produce evidence that they actually received prices less than NGPA ceiling prices.

Whatever course the MMS takes on NTL-5, the essential requirement is that royalty be paid on the true value of production which is best reflected in what the producer actually receives. No other approach is fair and no other approach is lawful.

Thank you for this opportunity to address NTL-5. I welcome any questions you might have.

# # #

Senator MELCHER. How old are those leases that have that reference?

Ms. PATTON. Many of the leases provide for that specifically. There is language in the existing Code of Federal Regulations that——

Senator MELCHER. No. I'm talking about the leases. When was that type of language incorporated in any lease? Is it fairly recently?

Ms. PATTON. No, 30 CFR which is the basis for the reasonable value has been incorporated in the lease language I think for approximately 40 years.

Senator MELCHER. All right. Thank you. It is not something new.

Mr. NEUMANN. No, sir.

Ms. PATTON. No.

Mr. NEUMANN. Hence, the Secretary could utilize the jurisdiction of the Code of Federal Regulations to determine that reasonable value be something somewhat different than the actual proceeds received.

Senator MELCHER. Well, let's see. How old is NTL–5?

Mr. NEUMANN. It was adopted in May 1977.

Senator MELCHER. In 1977.

Mr. NEUMANN. Yes, sir.

Senator MELCHER. Now, 30 CFR 206.103 is the basic regulation of Interior pertaining to this matter. Does NTL–5 in 1977 in your opinion track with 206.103?

Mr. NEUMANN. No, sir, not as it operates today.

Senator MELCHER. No, in 1977.

Mr. NEUMANN. Oh, in 1977. Yes, sir, it did.

Senator MELCHER. So, what leases are based on is really 30 CFR 206.103. Is that correct in your judgment?

Mr. NEUMANN. Yes, sir.

Senator MELCHER. So, when NTL–5 is modified and not tracked with 206.103, that is where we get out of sync, is it not?

Mr. NEUMANN. Yes, sir.

Senator MELCHER. Thank you.

The legal analysis you gave the Department on the two, this regulation and then NTL–5—do you still take that position? You don't have anything to add to that?

Mr. NEUMANN. You're referring to which legal analysis?

Senator MELCHER. API provided for the Department, specifically Cities Service provided for the Department a legal analysis of 30 CFR 206.103 and NTL–5.

Mr. NEUMANN. Mr. Deale will address that for API.

Senator MELCHER. All right.

Mr. DEALE. There may be two parts to the answer here, Mr. Chairman. Several of the member companies submitted comments, including Cities, and they can speak for themselves. API did submit comments which I think are in all respects consistent with the Cities Service comments.

Our position, as far as the legal argument is concerned, is to the extent NTL–5 at the time it was instituted was consistent with the regs, times have changed considerably and it is clearly not reasonable now. So, that is one-half of our legal analysis. At this point in time NTL–5—since 1982 NTL–5 had ceased to be reasonable and,

therefore, on the basis of the statute and the regulations was unreasonable and should be rescinded.

There is another aspect which API addressed at length in our comments, a legal issue dealing with retroactivity. I think we pointed out two things. One is retroactivity is really a misnomer for what was happening here. We weren't looking for Interior now to change its minds about what it did before. Rather we were urging the Department of the Interior to make a change which was long overdue, which they knew was long overdue, which they announced to the world several years ago was about to happen—our whole point was it is about time you did it.

And we cited several cases which point out—where courts have looked at situations where for a variety of reasons changes had to be made later in time than they might have been. We cited many cases which point out that the court will seek to render individual justice. We feel there is a substantial base of legal authority to justify the kind of action that the MMS is contemplating in its January proposal.

Ms. PATTON. I would like briefly to comment. NTL–5 was issued pursuant to 30 CFR—well, it was 221 at that time. That provides that in determining what the amount or value of production removed or sold is that it is the estimated reasonable value determined by the Secretary. NTL–5 in 1977 was issued as an estimated reasonable value for ceiling prices. From 1977 until 1982 that was a reasonable value, perhaps coincidentally, but it was. From 1982 onward, NTL–5 ceased to be a reasonable valuation methodology when the majority price in the field was marketing out to prices below that.

What Mr. Bettenberg said earlier today was very interesting, that they viewed NTL–5 as interpretive. That has always been the Cities position and basically what Mr. Deale was saying that so long as NTL–5 resulted in a reasonable parameter of valuation, it was consistent with the Secretary's underlying authority under 30 C.F.R.

When NTL–5 exceeded the bounds of reasonableness, which clearly if ceiling prices at $6.23 and you are getting substantially less than that, it is no longer reasonable. We do not feel the Secretary can legally enforce a value that is not reasonable.

Senator MELCHER. I don't either. But I must point out that I am just like other people that use the English language and understand the English language. And when you say that a ceiling price is—I think you confuse the issue by saying that a ceiling price may be reasonable, but to indicate that a ceiling price is the maximum limit of reasonableness I think is inaccurate. In 1977, well, you might have had a ceiling price that fit within the area of reasonableness. The fact that it is called a ceiling price seems to indicate to me in the English language that it might be beyond reasonableness.

That is exactly what has happened. You still have a ceiling price. It isn't a market price. It isn't in the real world anymore.

Ms. PATTON. That's correct.

Senator MELCHER. Now, just so I can be sure that you understand what other attorneys think, the Solicitor at the Department of the Interior says that NTL–5 has the force and effect of a regula-

tion. And if you just take those few words, that would mean that it could supersede—whatever the other one is—CFR 206.103.

Ms. PATTON. That's correct.

Senator MELCHER. Now, how do you like that?

Ms. PATTON. That is there position, and they have cited it in numerous appeals that I have. And I think that is the only position they can take. The fact is in——

Senator MELCHER. That's the only position they can take?

Ms. PATTON. In defense of what they are claiming. We have claimed because 206.103, the basic premise by which NTL–5 was promulgated, the reasonable value—NTL–5 was issued in 1977. The underlying regulation was reissued in 1982, the basic royalty valuation. It says it will be a reasonable value and the Secretary may consider these four or five factors, including the price received by the lessee. That regulation has been in existence ever since NTL–5 was implemented. If they had intended that NTL–5 supersede and totally replace that regulation, they should not have reissued the basic underlying regulation in 1982.

Essentially you have two methodologies for valuation of onshore gas at all times from 1977 to the present. You have 30 CFR which says it is reasonable, and you have NTL–5 which at times results in an unreasonable value.

Senator MELCHER. Well, in 1982 there was one solicitor, in 1985 a different solicitor. There was a different solicitor in 1985. How long has Tarr been there? He's the current one, isn't he? He was last night. It hasn't been changed. And he is the third one. He has been there since sometime last year.

So, the long and the short of it is you can't collect a royalty out of something you never collected in the first place. Is that correct? That is your testimony.

Mr. NEUMANN. Yes, sir. That is the basis of our testimony.

Senator MELCHER. And that is what the law should be. That is the way I understand the law. Is that the way you understand the law?

Mr. NEUMANN. Yes, sir.

Senator MELCHER. Thank you. Thank you very much, all of you for your help on this.

Mr. NEUMANN. Thank you, sir.

Senator MELCHER. Now, we are going to hear from the tribes, the Shoshone and Arapahoe and also from the Southern Ute.

Now, I suspect we would be just as well off—you may have differences, different interpretations. I don't know. But I suspect we would be just as well off if we hear from you all at the same time.

The way I have got it is John Washakie goes first. Is that acceptable?

Mr. WASHAKIE. Yes. This is Mr. Collins. We are both from Wind River.

Senator MELCHER. All right. Please proceed, John.

STATEMENTS OF JOHN WASHAKIE, CHAIRMAN, SHOSHONE BUSINESS COUNCIL, FORT WASHAKIE, WY; AND GARY COLLINS, CHAIRMAN, NORTHERN ARAPAHOE TRIBE, FORT WASHAKIE, WY; ACCOMPANIED BY TOM ASAVITO, ATTORNEY, ARAPAHOE TRIBE; SUE WILLIAMS, ATTORNEY, SHOSHONE TRIBE; ALAN PARKER, CHAIRMAN, ECONOMICS DEPARTMENT, UNIVERSITY OF NEW MEXICO; AND DAVID LEEDS, ERNST & WHINNEY, TRIBAL ACCOUNTANT

Mr. WASHAKIE. I would like to thank you for this opportunity and introduce some people that are here with me. Mr. Collins is the Chairman of the Arapahoe Tribe; Mr. Tom Asavito, Attorney for the Arapahoe Tribe; Sue Williams, attorney for the Shoshone Tribe. And we have two other people here today. We have Alan Parker, Chairman of the Economics Department, University of New Mexico, who is a consultant to the tribe in the Wind River case, as well as I believe an expert witness in the Supron case. We have Mr. David Leeds of Ernst & Whinney, the tribal accountants. And they may assist us here with some of the questions.

We are here today to testify on the effects of the proposed modification to NTL-5 and upon the affected—I can't even read my own statement. We would hope that our prepared statement would be included in the record.

Senator MELCHER. It will, John, in total.

Mr. WASHAKIE. Let me say at the outset that the Wind River Tribes remain strongly opposed to, and existing mineral leasing laws, any application of NTL-5 either prospectively or retroactively which might lower the royalty obligations owed tribes.

Further the Federal trust responsibility as embodied by the exiting laws and leases mandates the Secretary of Interior to maximize tribal royalties by employing the highest royalty yielding valuation method as described in either the Federal regulations, tribal leases or NTL-5.

I would now like to note several particular points of opposition with regard to the proposed modifications to NTL-5. First, the trust responsibility of the MMS to the tribes precludes any retroactive application of NTL-5 which would reduce royalties owed to Indians. Several recent court decisions, including our suit with the Department of Interior, have noted this point and made clear that the Secretary has a trust responsibility to oversee Indian mineral leasing activities pursuant to a standard of care much higher than the minimal care required by law.

For one, as a fiduciary the Secretary is required to oversee the Indian mineral leasing activities so as to achieve the best interests of the Indian tribes. In addition, the Secretary has been notified that administrative convenience and practicality may not be prime considerations in carrying out his trust responsibility to Indians.

Second, the Secretary is required to consider the true market value of Indian oil and gas for royalty purposes before selecting the valuation method which yields the greatest royalty for tribes. While this methodology may be in excess of gross proceeds or Federal limitations, courts have upheld this valuation for tribal royalties.

The Federal mineral leasing laws also impose a special trust responsibility upon the Secretary requiring him to employ only those retroactive valuations which serve to increase and not decrease as those currently proposed would do.

On a final note, we have not indicated a specific dollar amount as to the effect retroactively applying NTL–5 would have upon Wind River. This is due to the lingering question of whether the lessees or MMS have determined values at Wind River in accordance with their legal mandates without knowing precisely. What valuation was employed to pay royalties, the tribes are unable to determine whether an alternative valuation method should have been utilized because it yields greater tribal royalties and whether MMS intends to employ such a method.

I would now like to introduce Gary Collins, the Chairman of the Arapahoe Tribe, who will provide the subcommittee with several additional points.

Senator MELCHER. Go right ahead, Gary.

Mr. COLLINS. Thank you, Mr. Chairman.

Mr. Chairman and members of the subcommittee, as stated, my name is Gary Collins and I am Chairman of the Northern Arapahoe Tribe at Wind River.

I am here testifying before you along with Chairman Washakie. I would like you to know that I concur with the points made by Chairman Washakie and would like to add a few of the following comments.

Initially the members of the subcommittee and the Chairman must be aware that two issues are involved in the moratorium, only one of which is at issue today. To believe settlement of NTL–5 is all that is needed ignores that product value regulations involve enormous problems relative to the administration fulfilling the U.S. trust responsibility to the tribes.

Several options exist for the lessee unable to procure gross proceeds equal to determine value of the gas, such as temporary well shut-ins, temporary royalty relief, and temporary taxation relief. The Wind River Tribes have worked closely in the last few years with our lessees to try to achieve maximum gas sales prices and to provide temporary relief to lessees where necessary. We know all too well that bankrupt gas operations are not in our best interests, and this subcommittee can be assured that the Indians will be among the first to insure such disasters do not occur.

The second point is that the eleventh circuit decided in 1984 that a Federal agency may not apply its regulations retroactively when to do so would be contrary to statutory design or to legal and equitable principles. The companies claim they are victims of uncertain circumstances, and thus now they should be assisted with retroactive rulemaking. This simply is not the case. Under NTL–5 the companies had the authority to ask MMS to redetermine their royalties in light of equities. The companies failed to do so. Thus, they are now with unclean hands. Congress should not assist companies who fail to help themselves when they had the opportunity to do so.

A 1986 decision of the D.C. Circuit indicated that a Federal agency may not impose liabilities retroactively when the individual tribe—yes, individual tribe or has acted in accordance with the

agency's own announced interpretation of a statute. The Wind River Tribes, which currently suffer from an unemployment rate of—on our reservation—of nearly 70 percent, have relied reasonably upon the royalty income which should have been collected.

The companies' reliance upon informal MMS statements that NTL–5 would be disregarded is unjustified because no law would support reliance upon informal opinions.

Finally, in light of the Federal trust responsibilities to the Indians, no retroactive rulemaking with respect to Indian leases should be sanctioned because it imposes uncertainty upon Indian leases and thereby diminishes the value of these leases.

For the foregoing reasons, the Wind River Tribes urge the subcommittee to direct the MMS to fulfill its trust responsibility to Indian lessors and thereby help reduce the financial burden of protracted litigation to insure compliance that that responsibility would have upon the affected tribes. We submit the retroactive application of the modified NTL–5 is not merely bad policy, but in any event cannot be applied in such a way as to reduce tribal royalties due. Instead, tribal royalties are required by Federal law to be calculated through consideration of a variation of valuation methods, including those described in NTL–5, with the method yielding the greatest tribal royalties being employed by the Secretary. Thus, under no circumstances should companies be excused from paying full royalties due to the Indians.

The tribes urge the subcommittee to provide direction to the MMS by making clear that Federal laws, which impose trust duties upon the Secretary to maximize tribal royalties, preclude MMS from applying the modified NTL–5 retroactively to reduce Indian royalty obligations. Companies which feel overburdened should turn to the Congress or the tribes for relief and not the MMS.

This concludes our prepared testimony, and on behalf of Mr. Washakie and myself, we are prepared to answer any questions that you may have.

[The prepared statement of Mr. Washakie and Mr. Collins follow:]

TESTIMONY OF THE
SHOSHONE AND ARAPAHOE TRIBES
OF THE WIND RIVER RESERVATION
BEFORE THE SENATE ENERGY
AND NATURAL RESOURCES COMMITTEE
SUBCOMMITTEE ON MINERAL RESOURCES DEVELOPMENT
AND PRODUCTION
JULY 10, 1987

The Shoshone and Arapahoe Tribes of the Wind River Reservation ("Tribes") are grateful for the opportunity to testify before the Subcommittee concerning the proposed rulemaking of the Minerals Management Service ("MMS") described in the January 15, 1987 Federal Register. The rulemaking would affect a retroactive application of earlier modifications to Notice to Lessees and Operators of Federal and Indian On-Shore Oil and Gas Leases (NTL-5). Those modifications were initially published in the Federal Register on July 25, 1986, and expand the valuation methods that the MMS may consider in setting gas values for royalty purposes on Indian and federal leases.

The Wind River Tribes remain strongly opposed to, and existing law prohibits, any application of NTL-5, either prospectively or retroactively, which would result in tribal royalties lower than would be due upon the vigorous application of the highest royalty yielding valuation method described in the existing federal valuation regulations at 30 C.F.R. Part 206, NTL-5 or in the tribal leases. Stated in reference to the issue at hand, any retroactive application of NTL-5 that would result in decreased royalty obligations to the Tribes, whether reflected in a refund requirement or decreased royalties owed by the companies conflicts fatally with the Indian mineral leasing laws, the Indian leases, and the federal trust

responsibility to the Tribes which arises under these laws and leases. Recent judicial decisions make clear that such trust responsibility requires the Secretary of the Interior ("Secretary") to maximize tribal royalties by employing the highest royalty yielding valuation method of those methods described in the federal regulations, leases, or NTL-5.

The Tribes respectfully urge the Subcommittee to provide clear direction to the MMS to fulfill its trust responsibilities to Indian lessors. Failure to provide such guidance likely will force tribes to expend scarce financial resources to litigate their rights to royalties. In light of the severely depressed tribal economies, and an ever increasing need for governmental services on the reservations, overburdened tribes are better served expending our scant resources promoting employment and providing essential services on the reservations.

We will now summarize the factual and legal arguments in support of our position.

POINT 1: The MMS has a trust responsibility to maximize tribal royalties, which responsibility precludes a retroactive application of NTL-5 that would reduce royalties owed to Indians. Several courts now have construed the federal laws governing Indian mineral leasing as creating a trust responsibility between

the United States and the Indian tribes. See, for example, Jicarilla Apache Tribe v. Supron Energy Corporation, 782 F.2d 855 (10th Cir. 1986), cert. denied, 86-224 and Shoshone Indian Tribe and Arapahoe Indian Tribe v. Hodel, No. C81-131-K, (D. Wyoming January 7, 1987). These decisions, among others, make clear that the Secretary has a trust responsibility to oversee Indian mineral leasing activities pursuant to a standard of care much higher than the minimal care required by general administrative law principles. Specifically, in acting as a fiduciary, the Secretary is required to oversee Indian mineral leasing activities so as to achieve the best interests of the Indian tribes. That obligation has been interpreted in two ways. In one case, Supron, the en banc panel of the Tenth Circuit Court of Appeals held that as to the Secretary's trust duty to value mineral leases, the Secretary must apply whichever valuation method yields the Tribes the greatest royalties. That construction of the Secretary's obligation is based on, among other things, a recent United States Supreme Court decision, Montana v. Blackfeet Indian Tribe, 105 S.Ct. 2399 (1985), in which the Court construed the obligations imposed upon the

Secretary in the Indian Mineral Leasing Acts. One of those obligations is to achieve maximum returns for the Indians from their oil and gas. Similarly, in Shoshone Indian Tribe, the court held the Secretary must consider all reasonable choices for valuation which have some foundation in the lease provisions or the regulations and then choose the valuation method which is in the Tribes' best interest (i.e., that method which yields the greatest royalty). Importantly, the court emphasized that administrative convenience and practicality may not be prime considerations for the Secretary in carrying out his trust responsibilities to Indians. In Shoshone Indian Tribe, there was no challenge levied upon the regulations themselves.

POINT 2: The Indian mineral leasing laws require the Secretary to consider a true market valuation of Indian oil and gas for royalty purposes among the valuation methods before selecting the method that yields the greatest royalty. Such a market valuation would consist of a comparison of various prices of gas sales in common geographic regions. In some instances the market valuation may yield a value of the Indian gas that is in excess of either

gross proceeds or even any price limitations imposed by federal regulations. Such an occurrence has been upheld judicially as a generally acceptable oil and gas valuation approach for royalty purposes. See, for example, Continental Oil Company v. United States, 184 F.2d 802, (9th Cir. 1950), cited in the MMS' proposed rulemaking at 52 Fed. Reg. 1671 (January 15, 1987). In addition, the federal mineral leasing laws impose a special trust responsibility upon the Secretary of the Interior which responsibility requires valuation methods which are independent of and supersede any pricing restrictions imposed upon the lessees by other federal laws, such as the Natural Gas Policy Act. Stated in reference to the issue at hand, retroactive application of the modified NTL-5 to Indian leases can be employed only to increase rather than decrease tribal royalties.

POINT 3: Where payment of an Indian royalty consistent with federal laws becomes burdensome upon a lessee who is not able to procure gross proceeds equal to the determined value of the gas, several options are available to the lessees to alleviate their burdens. The lessees can request of the Indian lessors temporary shut-ins, temporary royalty

relief, temporary taxation relief, or other relief deemed reasonable and necessary. Indians are interested in obtaining the highest return from their gas resources. That highest return may mean that production should be curtailed temporarily or expanded depending on the circumstances of the market. The Wind River Tribes have worked closely in the last few years with our lessees to try to achieve maximum gas sales prices and to provide temporary relief to lessees where necessary. Other tribes, too, are certainly most willing to analyze requests for relief on a case-by-case basis or to provide marketing assistance to lessees. Bankrupt gas operations plainly are not in the Indians' best interests, and the Members can be assured Indians will be among the first to ensure such disasters do not occur. In addition to relief from the tribes, NTL-5 provides for relief through modification of the royalty valuation base. Also FERC, upon application, allows the "pass-through" of additional royalties into the rate base.

POINT 4: An agency may not apply its regulations retroactively when to do so would be contrary to statutory design or to legal and equitable principles. Buccaneer Point Estates, Inc. v.

United States, 729 F.2d 1297 (11th Cir. 1984). Furthermore, an agency may not impose a liability retroactively when the individual has acted in accordance with the agency's own announced interpretation of a statute. International Union, United Automobile, Aerospace & Agricultural Implement Workers of America v. Brock, 783 F.2d 237 (D.C. Cir. 1986). The proposed retroactive application by Interior is equally suspect under either reasoning, especially in light of the high federal fiduciary duty owed to Indians. That duty requires that Indian interests be protected vigorously, which protection does not occur if, after the fact, rules of the game are changed so as to result in lowered royalty obligations to Indian tribes. A fact reflected and acknowleged by the MMS in its July proposed rulemaking revisions of NTL-5. Indian tribes desperately are in need of royalties in light of the extremely high unemployment on Indian reservations, which currently is averaging approximately 70% at Wind River, and in light of the severe need for essential governmental services to be provided to most reservation residents. States provide few, if any, of such services, leaving tribal governments

as the main service providers on reservations. In short, Indians are extremely reliant on royalty income to meet their desperate needs, and the United States has a trust responsibility to maximize that income. Maximizing Indian gas revenues is difficult where the United States does not provide clear guidance as to the method for calculating royalties, and engages in a policy of changing those rules on an ex post facto basis. Both lessors and lessees suffer where uncertainty in the development of Indian oil and gas is imposed. The existing case law makes clear that only in very rare circumstances may retroactive rulemaking be sanctioned judicially, and the instant circumstance does not fall within the rare circumstances exception. For example, in Continental Oil Company v. United States, 184 F.2d 802 (9th Cir. 1950), the oil and gas lessees claimed that the United States could not make retroactive rules regarding valuation and succeeded in their claim, and in Alaskan Arctic Gas Pipeline Co. v. United States, (9 Cl. Ct. 723 (1986) companies succeeded in their claim that Interior could not apply application fees retroactively even when the statute directing the promulgation of

> regulations assessing the fees was in effect when the costs were incurred. In the case at hand, some of the very same companies now claim that the United States can engage in retroactive rulemaking because now it is to their benefit. The companies claim that they are overburdened and, thus, in light of the equities, are entitled to value determinations which yield less royalty obligations. Plainly, however, the most overburdened of all of the parties in this matter are the Indians. Moreover, Indians are entitled to special federal fiduciary protection of their interests in their gas. Finally, gas prices are increasing, undermining the argument that lessees are unable to pay royalties due. For these reasons, retroactive rulemaking ought not be sanctioned with respect to Indian leases because the law and the equities plainly favor the Indians.

To summarize, the Wind River Tribes submit that the retroactive application of the modified NTL-5 is bad policy and, in any event, cannot be applied in such a way as to reduce tribal royalties due. Instead, tribal royalties are required by federal law to be calculated through consideration of a variety of valuation methods, with the method yielding the

greatest tribal royalties being employed by the Secretary. In other words, NTL-5 is not the exclusive method to be used by the MMS in valuing Indian gas pursuant to MMS's duty to achieve maximum Indian royalties. Accordingly, if anything, a revisiting of royalties due Indians should result in increased royalties. The Tribes, therefore, respectfully urge the Committee to provide direction to MMS by making clear that federal laws which impose trust duties upon the Secretary to maximize tribal royalties preclude MMS from applying the modified NTL-5 retroactively to reduce Indian royalty obligations. If the companies are overburdened, they should obtain relief from the Congress or the tribes, or through established federal regulatory procedures, not the MMS.

The precise dollar impact upon the Wind River Tribes of the proposed retroactive application of NTL-5 is not clear to the Tribes, because the Tribes are unaware of whether the lessees or MMS have determined values at Wind River in accordance with the legal mandates, described in Supron v. Shoshone Indian Tribe. Without knowing precisely what valuation was employed to pay royalties, the Tribes are unable to determine whether an alternative valuation method should have been utilized because it yields greater tribal royalties and whether MMS intends to employ such a method.

The Wind River Tribes again express their appreciation for the opportunity to testify on this important issue. We will

now answer any questions the Subcommittee may have on proposed modifications to NTL-5.

Senator MELCHER. We do have some questions. But before we do that, let's get the testimony of Mr. Orian Box from the Southern Ute Indian Tribe and see if their testimony is similar.

STATEMENT OF ORIAN BOX, COUNCIL MEMBER, SOUTHERN UTE INDIAN TRIBE, IGNACIO, CO, ACCOMPANIED BY TOM SHIPPS, TRIBAL ATTORNEY; AND KAREN ANDERSON, PETROLEUM ACCOUNTANT

Mr. Box. Thank you.

Mr. Chairman, I am Orian Box, member of the Tribal Council of the Southern Ute Indian Tribe. In behalf of the Tribal Council and the tribe, I wish to thank you for allowing our tribe to come before you today in regard to NTL–5.

Here with me today are Tom Shipps, Tribal Attorney, and Karen Anderson, the tribe's oil and gas accountant. Both Tom and Karen have worked on issues related to royalty evaluation closely for several years. They will be available to answer any questions which you may have.

I am here to tell you the Southern Ute Tribe is strongly opposed to changing NTL–5 retroactively. The proposed rule would cost the tribe an estimated $7.6 million in royalties due and owing from oil and gas producers between 1982 and 1986.

For those who don't know, the Southern Ute Indian Tribe is one of two tribes located in Colorado. The San Juan Basin, one of the Nation's largest gas fields, extends into our reservation. Our tribal government and our tribe rely heavily upon royalty revenues for existence. Our unemployment rate is high, and these funds are vital to our tribe's wellbeing. We are greatly concerned that MMS is willing to excuse nonpayment of royalties at the expense of our tribal members.

To discuss these issues in more detail, I would now like to call upon Tom Shipps.

Thank you.

Mr. SHIPPS. Mr. Chairman, my name is Tom Shipps. I am Tribal Attorney for the Southern Ute Indian Tribe.

The Southern Ute Indian Tribe has prepared a written statement which we would like to have incorporated in the record.

Senator MELCHER. It will be made part of the record in its entirety.

[The prepared statement of Mr. Box follows:]

TESTIMONY OF THE SOUTHERN UTE INDIAN TRIBE:
ORIAN BOX, SOUTHERN UTE INDIAN TRIBAL COUNCIL MEMBER;
THOMAS H. SHIPPS, TRIBAL ATTORNEY;
KAREN ANDERSON, PETROLEUM ACCOUNTANT

BEFORE THE SUBCOMMITTEE ON
MINERAL RESOURCES DEVELOPMENT AND PRODUCTION
COMMITTEE ON ENERGY AND NATURAL RESOURCES
UNITED STATES SENATE
WASHINGTON, D.C. 20515

Chairman Melcher and Members of this Distinguished Subcommittee:

The Southern Ute Indian Tribe is grateful for the opportunity granted by the Subcommittee to present testimony regarding Notice to Lessees-5 (NTL-5). The Southern Ute Indian Tribe has followed the emergence of this issue closely for several years and the Tribe has participated actively in discussions of NTL-5 in numerous forums. As a major gas producing Tribe and as an active member of a larger Native American community, the Southern Ute Indian Tribe is gravely concerned by the direction the Secretary of Interior is taking in Indian resource management, and the Tribe is particularly concerned about the proposed retroactive modification of NTL-5.

A. NTL-5 Modification and Impact

NTL-5 was issued on May 1, 1977, pursuant to the authority conferred upon the Secretary by 30 CFR §221, in order to establish royalty values for gas produced from federal and Indian leases. The obligation to pay royalties under federal and Indian leases is tied to a percentage of the value of the products produced or sold. The United States has consistently maintained the position that value is not necessarily equal to the gross proceeds received by the producer for leased products, but rather fair value for federal and tribal resources may exceed the amount realized in the sale of those products. See, Continental Oil Co. v. United States, 184 F.2d 802 (9th Cir. 1950); United States v. Ohio Oil Co., 163 F.2d 633 (10th Cir. 1947), cert. denied, 333 U.S. 833 (1948), reh'g denied, 333 U.S. 865 (1948). For wells commenced on or after June 1, 1977, NTL-5 generally established a base royalty value which could be no less than the highest applicable ceiling rate established by the FPC or its successors for gas of the same category.

It is the Tribe's understanding that promulgation of NTL-5 was not opposed by industry. Commencing in approximately 1982, gas purchasers who had previously been willing to pay ceiling prices to operators and lessees, insisted upon lower purchase prices for gas. This decline in gas prices was largely due to the abundant supply of gas available as a result of increased drilling and production activity in the early 1980's. The general trend of lower gas prices, however, affected individual producers differently. NTL-5(III) provided for possible amendment of base royalty values to reflect the collectability of ceiling prices, yet it is unclear the

extent to which individual producers petitioned for reduction of base royalty values. Companies that failed to seek amended lease royalty rates and that now request retroactive modification of NTL-5 are essentially seeking rewards for ignoring federal regulations.

While hindsight may indicate that earlier modification of NTL-5 might have been justified, the unpredictable nature of gas production levels and gas markets in 1983 and 1984 could just as easily have made modification of NTL-5 a drastic mistake. In the latter part of 1984 and early 1985, the utilization of spot gas sales grew from an almost nonexistent market to a dynamic force further depressing gas prices. If this dramatic gas marketing shift had been foreseen, it is possible that NTL-5 might have been amended more quickly; however, the efficacy of legislation and regulation seldom turns upon the crystal ball analysis now demanded by industry.

In January of 1986, the Minerals Management Service formally proposed amending NTL-5 in a manner that would allow MMS more discretion in determining royalty value. Essentially, the modification proposed to allow MMS to redetermine a base royalty value in accordance with any method permitted by the regulations governing gas valuation (30 CFR §206.103 for federal lands, and 25 CFR §211.13 for Indian lands). At that time, MMS also requested comments on effective retroactivity of such modification to March 1, 1984.

In the comments it submitted on February 25, 1986, the Southern Ute Indian Tribe recognized the need of departing from regulated ceiling prices as the measure of royalty value. The Tribe was equally concerned, however, with the suggestions of various MMS officials that discretionary royalty valuation was actually another name for equating royalty value with the gross proceeds received by the lessee for delivered gas. Such a concept of valuation had the potential for under-valuation of tribal gas in contravention of standard Indian leases and long-standing policy. Finally, on the issue of retroactivity, the Southern Ute Indian Tribe claimed that replacing NTL-5 requirements with discretionary redetermination dating back to 1984 would be an unconstitutional taking, a breach of the federal trust responsibility to Indian tribes, and an invitation to chaos. Following receipt of comments, MMS modified NTL-5 effective August 1, 1986, to provide for full discretionary value determination; however, the modification was prospective rather than retroactive in effect.

In declining to make NTL-5 modifications retroactive at that time, MMS stated:

> . . . MMS's royalty value regulations affect millions of dollars of royalties each month. Lessees and other payors must be able to rely on application of existing regulations without concern about a retroactive change months later which could have significant economic consequences. Because lessees and other payors must comply strictly with MMS's royalty valuation rules, it is concomitant upon MMS to ensure that its rules [are] credible and can be relied upon until changed prospectively.

51 Fed. Reg. 26761.

Pursuant to its most recent notice, MMS is again proposing retroactive modification of NTL-5 with different effective dates for the various categories of gas, commencing with May 1, 1982, for §107 gas. MMS has specifically requested comment on the issue of whether or not retroactive changes should apply to Indian leases. The Southern Ute Indian Tribe is opposed to retroactive application of modifications to NTL-5 to Indian leases and further asserts that application of the modifications to Indian leases before the effective date of August 1, 1986, would be unlawful. Additionally, the Southern Ute Indian Tribe views with incredulity the ease with which MMS now discards its previously cited perception of the necessity of finality and certainty in royalty valuation rules.

Audits performed by MMS have shown dramatically that industry as a whole did not comply with NTL-5. Once sales prices for gas dropped below regulated ceiling prices, many companies ignored NTL-5 and paid royalty based on gross proceeds rather than on the value of lease products as determined by the Secretary in NTL-5. Audits have uncovered significant findings of underpayment of royalties, and the effect of those findings, together with accrued interest, represent an unquantified, yet significant amount of past-due revenue to which tribes are entitled. It should be noted, however, that MMS has effectively prevented the issuance of final demands for royalties owing as a result of NTL-5 undervaluation for several years.

In proposing retroactive modification of NTL-5, the MMS has requested comment regarding the impact of the proposal on Indian lessors and whether tribal and allotted leases should be exempt from retroactive royalty valuation standards. The MMS invitation for such comment has been met with two very different reactions.

Initially, tribes have taken some solace in the fact that the federal government apparently recognizes that its obligations for Indian lease management may be different and more demanding than those affecting other federal properties. As outlined in more detail in other portions of these comments, the Southern Ute Indian Tribe believes that MMS lacks the authority to deprive tribes and allottees of revenues collected or owing under NTL-5 as promulgated in 1977.

On the other hand, however, the invitation to analyze the impact of proposed retroactive modification on tribes and allottees is essentially a hollow opportunity. With very few exceptions, tribes do not have petroleum accounting systems in place, and the data needed to project such impacts are not available to Tribes. Tribes who are noted for their relative sophistication in minerals management, such as the Navajo Nation, have indicated an inability to estimate with any sense of accuracy the loss in revenue that will result from retroactive modification of NTL-5. Individual allottees are simply helpless in evaluating the MMS proposal. Most startling is the implied admission that MMS does not know what the impacts of the proposed policy will be. Both the need for retroactive rule-making and the need for impact information are symptomatic of the basic

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inadequate performance of MMS in meeting its primary responsibility to establish an accurate system of revenue and production accounting.

The Southern Ute Indian Tribe has been extremely fortunate in establishing an internal capability to manage its oil and gas resources. The Energy Resource Division includes an accounting department that monitors monthly production and revenue on a well-by-well basis. The Tribe's petroleum accountant has participated actively in MMS audits pursuant to a cooperative audit agreement entered into between the Tribe and MMS. The Southern Ute system relies upon an accurate computerized data base that has been assembled at tribal expense during the last five years. The Tribal Energy Resource Division has made a well-by-well analysis of the impact of retroactive modification of NTL-5 on all reservation properties in which the Tribe and allottees have an interest. Attached as Exhibit "A" to these comments is a summary of the findings of the Energy Resource Division with respect to uncollected sums due and owing under historic valuation standards. Exhibit "A" is based upon a detailed computerized listing of each impacted tribal and allotted well, together with annual historic production, the basis for royalty payment, required payment under NTL-5, and a computation of the loss that would be attributed to retroactive modification to NTL-5.

As one may determine from reviewing the exhibits, the Tribe's projections of lost revenues are significant. The estimated loss to the Tribe and allottees, exclusive of interest, is $7,626,021.00. While this sum is almost insignificant when measured against the estimated revenue loss to the federal government, it represents a monumental loss of tribal revenue.

The Southern Ute Indian Tribe recognizes that the motivations behind retroactivity are borne from a concern about the oil and gas industry; however, reduced to its most basic level, the question truly is whether or not MMS is going to sacrifice the interests of Indians for the benefit of industry. After having determined in July of 1986 that prospective modification of NTL-5 was sufficient and that retroactive modification was not necessary, the present proposal appears to be an unfair and punitive federal action. As a Tribe whose revenues are derived almost exclusively from gas royalties, the Southern Ute Indian Tribe and its allottees are being asked by the Secretary to bear an inordinate burden, one they will not bear willingly.

B. Breach of Trust Duty

In its earliest judicial characterizations, the relationship of Indian tribes to the federal government was said to resemble "that of a ward to his guardian." Cherokee Nation v. Georgia, 30 U.S. (5 Pet.) 1, 17 (1831). This special relationship has evolved from one of anology to one in which the federal government, under the direction of Congress, is required to exercise its authority over tribes in conformity with exacting fiduciary obligations. While specific administrative duties regarding the approval and monitoring of activities on Indian lands are statutorily assigned to the Bureau of Indian Affairs, the scope of the federal trust responsibility requires all federal executive departments to protect the interests of tribes even when that protection may conflict with general

public goals or objectives. Pyramid Lake Paiute Tribe v. Morton, 354 F.Supp. 252 (D.D.C. 1972); Navajo Tribe of Indians v. United States, 364 F.2d 320 (Ct.Cl. 1966). In a more precise sense, the federal government's responsibilities in supervising the administration of tribal oil and gas properties requires the maximization of revenue for the benefit of tribal lessors. Jicarilla Apache Tribe v. Supron Energy Corp., 728 F.2d 1555 (10th Cir. 1984), rev'd on reh'g en banc 782 F.2d 8565 (1986), cert. den. ___ U.S. ___ (Nov. 17, 1986).

The proposed policy to deprive Indian tribes and allottees of monies due and owing under regulations in force until August 1, 1986, is a clear breach of the federal trust responsibility to Indians. The flagrancy of the disregard for Indian interests is compounded by the decision reached less than one year ago to restrict the effect of NTL-5 modifications to prospective application. To reverse that decision and expand retroactive effects to May 1, 1982, is a major abrogation of trust responsibility. In its rationale supporting a resolution recognizing the Secretary of Interior's special obligations to tribes, the Royalty Management Advisory Committee at its most recent meeting unanimously adopted the following language of Felix S. Cohen:

> [D]ecisions of the Supreme Court reviewing the legality of administrative conduct in managing Indian property have held officials of the United States to "moral obligations of the highest responsibility and trust" and "the most exacting fiduciary standards," and to be "bound by every moral and equitable consideration to discharge its trust with good faith and fairness."

Resolution of October 22, 1986, Secretary of Interior's Royalty Management Advisory Committee citing Felix S. Cohen, Handbook of Indian Law (1982 ed.) at 226.

Thus, the proposed modification conflicts not only with the long-standing duties of the Secretary, but also with the findings of an advisory committee which consisted of key representatives from industry, tribes and states.

C. Potential Infirmities in Retroactive Rulemaking

The real issue in this case is money. NTL-5 created in tribes a reasonable expectation and entitlement to revenue based upon its provisions. The adoption of a policy which deprives tribes of that revenue is one which can occur only in breach of federal fiduciary obligations. If the Secretary concludes that enforcement of NTL-5 will effect an unintended hardship on industry, his absolution of industry obligations can be conferred only with continuing federal accountability and fiscal responsibility for the tribal entitlement which NTL-5 created.

While no specific provision of the United States Constitution prohibits the promulgation of retrospective enactments, various provisions serve to limit the oppressive nature of such governmental actions. The due process clause and just compensation clause of the fifth amendment have long

served as protections against government action that would otherwise damage or impair contractual rights or property interests.

The leases issued by tribes pursuant to the Mineral Leasing Act of 1938 specifically required lessees:

> To abide by and conform to any and all regulations of the Secretary of Interior now or hereinafter in force relative to such leases. . . .

Additionally, the royalty provisions in said leases explicitly countenanced the authority of the Secretary to value lease products for royalty purposes at rates in excess of "the actual amount realized by the lessee from the sale of such products." The provisions of NTL-5 establishing the method for determining royalty value, created vested property interests and cognizable expectations in the royalties so valued. While prospective modification of NTL-5 is unchallenged, after-the-fact negation by the MMS of past due royalty obligations does not comport with the fundamental constitutional principles designed to prevent the government from confiscating the property of others.

D. Administrative Concerns

During the last five years a substantial amount of agency time, money and effort has been devoted to assembly of a computerized royalty collection and reporting system, AFS. The scope of the project has been enormous and it is not surprising that all has not gone smoothly. Efforts to bring AFS on line have unquestionably distracted MMS from audit activities. Perhaps, had more audits been completed, the problems associated with NTL-5 would also have been addressed in a more timely fashion. Audit activities in the last year have begun to reveal the magnitude of the deficiencies in royalty payments attributable to NTL-5.

The proposed modifications to NTL-5 will require substantial amendment to audits already completed. The revision of audit work already completed will necessarily impede the ability of auditors to conduct planned audit activities and will again place the agency in a position of taking two steps backward for each step forward. The Southern Ute Indian Tribe is extremely concerned about the ability of MMS to complete a thorough audit of the remaining 48 companies operating on the Southern Ute Indian Reservation within the time frames for company document retention and within the statutory limitations periods. Diversion of agency resources from the audit task will not serve the best interests of the Tribe. Because the Southern Ute Indian Tribe is under the impression that NTL-5 is presently the agency's standard for determining values for royalties due prior to August 1, 1986, there is considerable concern and confusion associated with current agency directives to disregard NTL-5.

Conclusion

In the interests of simplicity, MMS has proposed replacing NTL-5 with "gross proceeds" as the measure of royalty value. Adoption of this measuring stick for royalty value, whether retroactively or prospectively,

is a negation of the lease terms, a rejection of longstanding federal policy, and a practice which will result in undervaluation of products. The proceeds that a particular producer may receive, are simply not necessarily reflective of the fair market value of the product when compared to average prices received by other lease operators in the same area.

In summary, despite the fact that the Southern Ute Indian Tribe has committed no wrongdoing, the Secretary is asking that we forego collection of $7.6 million. The Tribe's expectation to that sum is based upon NTL-5, a measuring device promulgated by the Secretary in 1977. While we recognize the Secretary is concerned about NTL-5's effects on the oil and gas industry, and, indeed, the Tribe shares that concern, we do not believe that the Secretary can deprive tribes of sums due and owing. Should the Secretary conclude that industry debts be wiped away, it is our position that he remains morally and financially responsible to the Tribe and its allottees for that loss.

On behalf of the Southern Ute Indian Tribal Council, we thank you for giving us the opportunity and honor to address you regarding this critical issue.

Orian Box, Southern Ute Indian
Tribal Council Member

Thomas H. Shipps, Attorney
Southern Ute Indian Tribe

Karen Anderson, Accountant
Southern Ute Indian Tribe

PROPOSED RETROACTIVE CANCELLATION OF NTL-5
SUMMARY OF ESTIMATED PROBABLE LOSS
IN ROYALTY REVENUE
ACCRUING TO THE SOUTHERN UTE TRIBE AND ALLOTTEES
May 1, 1982 through July 31, 1986
(first revision)

			(1) ESTIMATED REDUCTION IN ROYALTY REVENUE
1982	NPGA 107	$1,013,846.00	
	TOTAL 1982		$1,013,846.00
1983	NGPA 107	$1,521,304.00	
	NGPA 108	80,586.00	
	TOTAL 1983		$1,601,890.00
1984	NGPA 107	$1,877,287.00	
	NGPA 108	124,930.00	
	TOTAL 1984		$2,002,217.00
1985	NGPA 103	$ 32,944.00	
	NGPA 107	1,789,553.00	
	NGPA 108	122,992.00	
	TOTAL 1985		$1,945,489.00
1986	NGPA 103	$ 101,913.00	
	NGPA 107	870,621.00	
	NGPA 108	90,045.00	
	TOTAL 1986		$1,062,579.00
	(2) TOTAL ESTIMATED LOSS		$7,626,021.00
	(3) LOSS ATTRIBUTED TO ALLOTTED LANDS		$ 228,781.00

(1) NGPA 107 = 107 (c)(5)/NGPA 103 includes 103(b)(1) and 103(b)(2) with depth less than 5000' for 1985 and 1986 estimates

(2) excludes NTL-5 valuation on wells commenced prior to June 1977, (stripper wells excepted) and excludes interest on late payments

(3) 3% of Total Estimated Loss

EXHIBIT "A", page 1 of 3

MMS PROPOSED ACTION TO RETROACTIVELY
CANCEL NTL-5

ESTIMATED PROBABLE ROYALTY REVENUE LOSS TO THE
SOUTHERN UTE INDIAN TRIBE AND ALLOTTEES
MAY 1, 1982 THROUGH JULY 31, 1986

ASSUMPTIONS AND PROCEDURES

ASSUMPTIONS

It was assumed that:

- The greatest impact would derive from new wells (as defined by the NGPA) therefore old wells were not included in the analysis (old stripper wells excepted).

- The Fruitland, Mesaverde and Dakota formations throughout the reservation should have been designated as tight formations (assumption supported by preliminary geological review).

- All lessees/operators were diligent in the inclusion of the appropriate language for incentive pricing in their contracts.

- All new production was dedicated to either intrastate or interstate sales on 4-20-77 (new production resulting from infill drilling as supported by the Colorado Oil and Gas Commission Order No. 112-46 dated 7-16-79).

- The June prices for gross proceeds and the NGPA ceiling price were reasonable mid-point prices for each year.

- Of the leased Indian lands held in trust within the Southern Ute Indian Reservation boundaries 3% are owned by individual allottees; therefore, 3% of the royalty revenue loss is attributed to allotted lands.

PROCEDURES

- All wells subject to the analysis were assigned an appropriate NGPA category for each year based on BLM records and the aforementioned assumptions.

- The gross proceeds price ("PRICE") was obtained from Tribal Severance Tax records.

- The price receivable under NTL-5 provisions ("NGPA CEILING") was obtained from FERC publications.

- The "PRICE DIFFERENCE" equals the "NGPA CEILING," less the gross proceeds price. When the "PRICE DIFFERENCE" was zero or negative, the well was omitted from the analysis (BTU adjustments in the gross proceeds price may have resulted in immaterial variances).

- The "ROYALTY VOLUME" was obtained from Tribal production records and was prorated when appropriate to reflect the various dates of retroactivity as proposed by MMS.

- The "ROYALTY REVENUE LOSS" equals the "PRICE DIFFERENCE" times the "ROYALTY VOLUME".

Mr. SHIPPS. Mr. Chairman, the Southern Ute Tribe is opposed to retroactive modification of NTL–5 for several reasons. First, standard tribal leases issued by the Bureau of Indian Affairs are value-based leases as opposed to proceeds-based leases. And I think earlier on, I think there was some confusion about that. The lease terms and longstanding Federal policy make it absolutely clear that royalty may be based upon values that exceed the gross proceeds actually received by the producer. And the purpose of a market value-based clause is to insure that regardless of the many factors that may be involved in the particular sales decision of the producer, tribal royalties will be based on a reasonable and favorable approximation of the value of the commodity.

Senator MELCHER. Mr. Shipps, just on that point because, one, I really want to understand the Southern Ute Tribe's position. Based upon value, is it the tribe's position that when the gas was selling for less than that value—and you can take any value you want, but let's take one that has been mentioned, the $6 and some cents ceiling price. Is it the Southern Ute Tribe's position that when the price went below that, that $6 and odd cents, the gas should have been shut in?

Mr. SHIPPS. No, Mr. Chairman. Not that the gas should have been shut in.

Senator MELCHER. How would the producer then find what to pay on the basis of a royalty if he didn't shut it in, if that was the tribe's position that that was the value they wanted for the gas?

Mr. SHIPPS. Well, keep in mind that with respect to many of these leases, Mr. Chairman, the royalty provision involves only maybe 12½ percent for old leases, 16⅔ percent for leases issued after approximately 1960 when the——

Senator MELCHER. I understand.

Mr. SHIPPS. So, the fact that the relatively small portion of the production will be valued at a higher level than the remaining 80 or 70 percent of the production does not economically necessarily preclude the producer from continuing to produce. It just means for that share he would pay at a higher value.

Senator MELCHER. In other words, if it dropped to—and let's take a one-sixth royalty. If it dropped to $4, just pay the royalty as if it were selling at $6, which might mean that you would still get a buck royalty. And it is selling for $4, so really the percentage would go up.

As was the case in many instances, gas dropped to around a buck and a half. I think that a lot of people that own the gas might want to say, well, leave it there. Was that the tribe's position, just leave it there?

Mr. SHIPPS. No, it was not, Mr. Chairman, to leave it there.

Senator MELCHER. Just keep going with it even though it was only bringing a buck and a half gross.

Mr. SHIPPS. We, as well as the producers, were very concerned about maintaining a regular income stream. This decision——

Senator MELCHER. I understand that. I'm just asking the tribe's position at the time.

Mr. SHIPPS. We did not ask that the wells be shut in, no, Mr. Chairman.

Senator MELCHER. Did you know that they might have been selling for as low as a buck and a half?

Mr. SHIPPS. Certainly.

Senator MELCHER. You did?

Mr. SHIPPS. Certainly.

Ms. WILLIAMS. Mr. Chairman.

Senator MELCHER. I want to get his testimony over with.

Ms. WILLIAMS. We have a response to that as well.

Senator MELCHER. I will get back to you on the same point.

Ms. WILLIAMS. Fine.

Senator MELCHER. Go right ahead, Mr. Shipps.

Mr. SHIPPS. NTL–5 was a secretarial directive which specified the Federal measuring stick of value for royalty purposes regardless of the sales price received by the lessee. The measuring stick that was applicable was the NGPA ceiling price for the particular category of gas.

Now, NTL–5 was not rigid in this regard, Mr. Chairman. NTL–5 III, as Mr. Collins has previously testified, provided that a producer could apply for an amendment of that base royalty value based upon his inability to collect those ceiling prices. The notice thus included the flexibility that we now are hearing was not present. And that is just not true. It had that flexibility. It provided the flexibility needed to permit the producers to escape the onerous effects related to actual market conditions. When prevailing market rates commenced their decline——

Senator MELCHER. Mr. Shipps, I hate to interrupt you again, but I think we might forget this point. The Department of the Interior during this time was sending out letters to the effect, go ahead. You can sell the gas for whatever you can get, and the royalty will be based on that price.

Mr. SHIPPS. Mr. Chairman, my understanding is the letters that were sent were informal correspondence that stated, listen, don't worry about NTL–5. One of these days we are going to change our regulations. And with the batteries of attorneys——

Senator MELCHER. The letter I read was different.

Mr. SHIPPS. I beg your pardon, Mr. Chairman. Many of the letters that I have seen talked in large part about some subsequent change in oil and gas valuation regulations, which is a different topic but related.

With the number of people that are involved with these companies, for a company to honestly have relied upon informal correspondence saying at some point in the future we are going to change the regulations and then not avail themselves of the specific remedy that was provided in the regulations for amending their base royalty, in our estimation is really after the fact now and an inappropriate characterization of what happened.

Most of the oil and gas producers—quite frankly they simply ignored it. If you were to look across the board, most of those oil and gas producers simply ignored the rule. Many of them did not send those letters. Many of them did not request a redetermination of their base royalty value. They just simply ignored the rule and they paid on gross proceeds. And they ignored their lease terms. We talked earlier about the primacy of these contracts, and the contracts quite frankly, Mr. Chairman, are being ignored in many

instances and were ignored by these producers during this entire period.

I will try to be quick. I am sure, Mr. Chairman, that we all can get very excited about this issue on both sides of the fence. And I think that we are both very concerned about the performance of MMS in this process as well.

The estimates that have been provided by the Minerals Management Service indicate that there is approximately $135 million total that would be due and owing under NTL–5 of which their estimates are approximately $8.5 million would be due and collectable by Indian tribes.

The Southern Ute Indian Tribe did complete an exhaustive well-by-well analysis where we went through on each well and took the price category, tried to develop what it would cost the Southern Ute Indian Tribe in terms of uncollected royalties. And our estimate was $7.6 million. The size of our finding alone in this universe of royalties that are owed Indian tribes leads us to seriously question the accuracy of the MMS estimates in this regard.

In 1986 when MMS first proposed modification of NTL–5, it concluded that retroactive revision was contrary to the overriding necessity for regulatory certainty. Thus, the modifications effective in August 1986 did not impose retroactive impacts. As MMS then recognized, operator noncompliance could not be lightly excused. We are opposed to retroactivity first because the producers in many instances flatly ignored the rules, failed to avail themselves of the remedies provided by the rules, and now seek to benefit from that noncompliance at our expense.

Second, the Southern Ute Indian Tribe is opposed to retroactive modifications based upon the Federal Government's trust duties, which previous people have spoken to.

I would just merely like to summarize that to adopt a rule with retroactive effects with full knowledge that the rule will deprive tribes of badly needed revenues is a major abdication of the trust duties. In an era in which tribes are expected to assume greater and greater roles in governmental management, the proposed action is punitive and is destructive of Federal Indian policy.

Finally, we oppose NTL–5 because of the questionable lawfulness of withdrawal of a tribal entitlement without just compensation. The expectation created by NTL–5 was a legal interest in accrued royalties which cannot be removed by administrative whim. The failure of MMS to pursue collection of NTL–5 is an additional matter about which we would present testimony from Karen Anderson, our auditor, regarding the actual administrative procedure and enforcement of NTL–5.

Ms. ANDERSON. Mr. Chairman, in the proposal to retroactively modify NTL–5, MMS requested that commenters provide estimates of the amounts that tribes and allottees would be required to refund if the recoupment provisions of the modification were included. The Southern Ute Tribe recognized that MMS had not fully collected NTL–5 valuation on the tribe's royalties.

Therefore, we went one step further. We did a well-by-well analysis. We did a computer printout of all the wells comparing gross proceeds prices to NTL–5 ceiling prices. The result was that the tribe would lose close to $7.6 million in uncollected royalties.

Senator MELCHER. Was that audit you're speaking of based on what? Was it based on actual price received or not?

Ms. ANDERSON. The price data that we used for the comparison was obtained from tribal severance tax records.

Senator MELCHER. In the audit that you did, well by each well, did you take the price received for the gas, or did you take some other figure?

Ms. ANDERSON. The price that we used, like I said, was from the severance tax records, and assumed——

Senator MELCHER. Was that from the price? I don't understand that, but was it from the price the producer received?

Ms. ANDERSON. Yes, sir.

Senator MELCHER. And you are saying that a producer—I am assuming most of these are one-sixth royalty, or are they one-eighth?

Ms. ANDERSON. One-eighth on the older leases and one-sixth on the new leases.

Senator MELCHER. Now, you are testifying that you audited wells where the price received was at a figure that you didn't get the proper royalty. In other words, if it was $4 gas and you took one-eighth, that would be 50 cents. Is that right? One-sixth, about 67 cents. And you did not receive that. Is that what you are testifying?

Ms. ANDERSON. No. What I am saying is that we took the price that was assumed to be the gross proceeds price.

Senator MELCHER. No, I am not talking about that. My question is—and I want to be sure I understand you and you understand me too—that this audit was based on gas sales at the wellhead and the royalty was computed on that basis not on some price that the producer might not have received. It was actually the price the producer received.

Ms. ANDERSON. Yes. I am going to have to explain this a little bit in detail. It is just a comparison between gross proceeds price and the provisions of NTL-5, NGPA ceiling prices.

Senator MELCHER. Now, you are saying then that if a higher price had been received, the royalty would have been greater. Is that correct?

Ms. ANDERSON. I am sorry, sir. I do not quite follow the question.

Senator MELCHER. Well, then let me rephrase it.

The audit was not based on the price actually received at the wellhead by the producer. It was not based on that.

Ms. ANDERSON. Yes, it was. The price that was compared to the NGPA ceiling prices was the price that the producer received at the wellhead.

Senator MELCHER. All right. You were auditing on two different figures: one actually received by the producer and then the other price being the ceiling price, the $6 FERC ceiling price?

Ms. ANDERSON. Well, $6 is certainly the highest.

Senator MELCHER. Yes, all right. But whatever the ceiling price.

Ms. ANDERSON. Yes, sir.

Senator MELCHER. So, then you subtracted what the producer—well, you took the higher price which the producer did not receive, and then you computed what would have been the royalty payment to the tribe based on the higher price not actually received. Is that correct?

Ms. ANDERSON. Yes, sir. And also based on the provisions of NGPA in qualification and all the technical requirements under NGPA for qualification for the different pricing levels.

Senator MELCHER. All right.

Ms. ANDERSON. A summary of that estimate is included in our written testimony.

I would also like to impress upon you, sir, that it is important that you be aware of MMS' policy regarding enforcement both past and current. MMS issued an internal directive on April 30, 1985 to ignore NTL–5. This directive preceded the first public notice of proposed modification by 8 months.

At that time MMS and the tribe jointly had just begun the very first audit of our royalties under our joint audit agreement. And since our joint audit agreement requires that we comply strictly with MMS policy, our findings for the most part were based upon the gross proceeds provisions of NTL–5 rather than the NGPA ceiling price.

Yet, we find that action on the audit findings that cite any provision of NTL–5, regardless of whether they are subject to modification, have currently been suspended. This was based on a March 5, 1987 directive from the Director of MMS. As a result of this policy, the MMS has suspended action on over $7,000 worth of appealed audit findings for the Southern Ute royalties which were based on fairly negotiated contract prices that the lessee himself had agreed to in his contract.

And that is pretty much our position on the non-enforcement issue.

Senator MELCHER. If I understand, Mr. Shipps, the leases for the Southern Ute Tribe were really pretty much the standard leases except in some instances they were a one-eighth royalty, in some instances a one-sixth royalty. Is that correct?

Mr. SHIPPS. That is correct, Mr. Chairman.

Senator MELCHER. Now, in your view did the FERC ceiling price represent the reasonable value of gas during the period 1982 to 1986?

Mr. SHIPPS. Most fundamentally I would have to say it probably did not. I speak for the Southern Utes.

Senator MELCHER. The Southern Ute Tribe's testimony is that NTL–5 would guarantee a price higher than what was reasonable, or did in effect provide a price that was higher than what was reasonable.

Mr. SHIPPS. Undoubtedly there are instances in which producers who are bound by the provisions of NTL–5 in that time period from 1982 to 1986 would have been required to pay at a price that was more for them than the reasonable value of that product. However, those were the same operators who failed to avail themselves of the remedies that could have excused them from that onerous impact.

Senator MELCHER. Well, Mr. Shipps, I would refer to the letter I had read, and I am just going to make it clear for the record what I am referring to. On August 4, 1983, a letter from MMS at Reston, Virginia, was sent to a Miss Jennifer A. Cates, attorney for Philips. The key paragraph—there are only four paragraphs in the letter, but the one that means anything says that "MMS will accept gross proceeds received under a properly negotiated arm's length con-

tract as the basis for calculating royalties on gas produced on Federal leases." Now, that does not say Indian leases, but I suppose the question was posed on the basis of Federal leases. That is the only way it can be as far as I know.

I think though if you have a provision in the lease that will permit you to shut the gas in because you do not want to sell it for that price, you can do so. Is there any such provision in the lease?

Mr. SHIPPS. The standard BIA lease forms that have been implemented and used by tribes and the Bureau of Indian Affairs generally lacked any kind of a shut-in royalty provision and lacked any kind of a shut-in royalty clause so that there was an obligation to continue to produce the wells in paying quantities in order for that lease to be continued to be retained by the producer.

Senator MELCHER. Well, obviously no one is going to produce more for a royalty than what the gross price was.

Mr. SHIPPS. And that is an exceptional provision. I think there were very few instances when in fact royalty ever exceeded what was totally received by the operators. Again, we have to keep in mind——

Senator MELCHER. No, I understand that.

Mr. SHIPPS [continuing]. We are only talking about the 12 percent.

Senator MELCHER. You just get shades of degrees. But obviously, if you are going to make the argument you did that why didn't the companies avail themselves of having the regulation clearly modified or whatever, the same argument can be made against Southern Utes, why didn't you say to shut the gas in because we want to save it for higher prices.

Ms. WILLIAMS. Mr. Chairman.

Senator MELCHER. Any response to that? I just want to allow Mr. Shipps to respond to that if you would, sir.

Mr. SHIPPS. I do not have any response to that.

Senator MELCHER. I think most of your argument goes to courts not to me anyway.

Yes?

Ms. WILLIAMS. Mr. Chairman, if I may on behalf of Wind River, there is I believe a misperception here. And we all may be talking about close to the same thing.

Senator Nickles from Oklahoma made the statement that he cannot believe—and for the uninitiated in the oil and gas arena, it is very hard to imagine that a producer would have to pay a royalty on a price or a value in excess of gross proceeds. That for the uninitiated is very much a legitimate question.

In the Indian leases, all of the leases are based on percent of value. And the question we are all faced with is how to set value. We are interested at Wind River in setting a proper market value for those leases. Our position, Mr. Chairman, is that assuming that each individual sales contract gross proceeds achieves market value for that product is simply fundamentally flawed.

Senator MELCHER. Flawed.

Ms. WILLIAMS. And it is flawed for several reasons. We have an economist here who might, if you wish, come forward and give you further information on this.

Senator MELCHER. Well, I think that the question of value and the question of whether the Indian leases are different than the Federal leases is a very valid point. And you are testifying that, indeed, they are different.

Ms. WILLIAMS. Absolutely different. All we are asking is that value be set by comparing prices in the equivalent economic region.

As you know, company sellers and company purchasers have relationships extending worldwide. We are not assured in each sale, supposedly arm's length, that in fact an arm's length sale occurred. There are non-monetary considerations that pass between these companies who have relationships that extend worldwide. To insure that a particular contract is based on arm's length and is the market value of that lease, MMS would be required to go throughout, indeed, perhaps the world to determine whether non-monetary consideration passed between these companies. In fact, in the proposed regulations of MMS on product value there is in one of those sections express recognition that non-monetary consideration passes between the purchasers and the sellers of gas.

Because of those non-monetary considerations, which we could never track on an audit trail, it is our position that in order to achieve true market value on Indian leases, a comparability analysis of all of the prices for comparable products in comparable regions has to be done.

The experience at Wind River for the period covered by the proposed rulemaking at issue here is that where companies had to pay royalties on a value in excess of gross proceeds and that payment would burden the companies, those companies came to the Wind River tribes seeking relief. They did not ignore the existing lease provisions. They did not ignore the rules in effect at the time. They came to the Wind River tribes and said, if we have to pay royalties to you, we will go bankrupt.

We have worked consistently with those companies affording them relief in a variety of ways, assisting them in the marketing of their gas. That is how overburdened companies ought to be dealt with in the Indian leases, not by going to MMS and having MMS set artificially low values upon which Indian royalties will be paid.

One additional point on the companies' reliance on informal communications from MMS——

Senator MELCHER. Then——

Ms. WILLIAMS. Yes, Mr. Chairman.

Senator MELCHER. Then to the extent the companies came to you and said here is all we can get for the gas and help us get more, you worked it out.

Ms. WILLIAMS. Absclutely.

Senator MELCHER. And on what basis then? The Southern Utes have said they think they have $7 million and a half coming. What do you think the Arapahoe and Shoshone have coming?

Ms. WILLIAMS. Mr. Chairman, we did not undertake a lease-by-lease audit as did Southern Ute. It is difficult to make an assessment of what we might be owed from the companies yet under the unmodified NTL–5. We are not clear on what basis the companies made their payments because at Wind River the companies are on notice that simply paying on gross proceeds is not adequate in light of the governing Federal Indian mineral leasing laws of 1938, 1916,

1924, 1891. These are special laws pertaining to Indian mineral leases that require payment of royalties on a value that may exceed the gross proceeds.

Those companies that knew they had to pay value in excess of gross proceeds and that that would afford them few opportunities to further produce came to the Wind River tribes and accommodations were worked out in a variety of ways. The Wind River tribes have worked with the Bureau of Indian Affairs to afford relief where shown as necessary.

Senator MELCHER. Are you testifying that the tribes have money coming or not?

Ms. WILLIAMS. We believe we have money coming to us, but we do not have, as the MMS indicated, audits to support that statement. We suspect there are money—just as Southern Ute has pointed out, the companies in many instances may have paid on gross proceeds, but we do not have an audit trail to support that position.

Our position is that MMS——

Senator MELCHER. The Department thinks that maybe $1.6 million might be the proper amount for the Shoshone and Arapahoe tribes combined. Is that within the ball park or not?

Mr. ASAVITO. Senator, if I may add to that. As you know, the Arapahoe and Shoshone tribes are in litigation against the Secretary of the Interior and several of the oil and gas producers on the Wind River Reservation on this valuation issue. If you have a figure before you, that must have been developed as a result of the court case and has not been made available to us.

The Secretary of Interior is under an order by Judge Kerr of the Federal District Court to conduct a series of valuation calculations pursuant to that litigation and present that to the court. That figure has yet to be made available to us.

Senator MELCHER. All right. Wait a minute. You were testifying on the basis of the Arapahoe, right?

Ms. WILLIAMS. I am counsel to the Shoshone Tribe. There are two tribes sharing the same reservation.

Senator MELCHER. Excuse me. You are testifying on the basis of Shoshone.

Ms. WILLIAMS. Correct.

Senator MELCHER. The Arapahoe is over here.

I am a little bit confused though. You said the companies full-well know that Indian leases are different, and that market value may not apply at all, and that royalties must be paid on perhaps a higher value than what they are receiving.

Now, you said companies come to you. Just some of the companies and made that arrangement, but not all?

Ms. WILLIAMS. Only a small number of companies came to us, Mr. Chairman, presumably because those are the companies that were overburdened.

Mr. ASAVITO. Senator, if I may add to what Ms. Williams is saying, is that the companies that did approach the Wind River tribes were the independents like your Chandler & Associates fellows that have a great difficulty in terms of meeting their obligations and they run on a very thin line. And they approached the tribes and said, we are having problems with respect to paying on

those amounts. Can you give us some relief? And they are not party to our litigation.

In addition, they asked to be able to choke back on those wells and produce at a smaller amount.

Senator MELCHER. What happened to the Shoshone happened to the Arapahoe. In effect you are united. You have each got an attorney sitting on the—one to your left, John, and one to your right. These two attorneys work together, right, just like the tribes do? All right. So, what I hear from either one of you reflects the position of the tribes. All right.

Is it fair to say this that the terms of the contract—the leases themselves are different for Indian tribes. That's number one.

Second, the terms themselves in connection with market value for the product is different—has a different interpretation—is that fair—than from Federal leases.

Ms. WILLIAMS. If I may, Mr. Chairman. The Indian leases have contained within them provisions describing value that are practically replicated in the governing lease value regulations. Whether or not Federal leases are substantially different than Indian leases on the definition or criteria for value is something that I do not believe that we are prepared to say at this moment.

I understand there are many value based Federal leases. We are not here to discuss those. We would need to review those before presenting an opinion to you on whether they are similar or identical to the Indian leases.

Senator MELCHER. Well, you came on pretty strong right at the start and said anybody that assumes that the lease means, in the case of Indian leases, the wellhead price is the value on which you compute the royalty, that is, to use your words, "fundamentally flawed."

Ms. WILLIAMS. And here is why, Mr. Chairman.

Senator MELCHER. Is that right?

Ms. WILLIAMS. Here is why, Mr. Chairman. There may be comparable definitions of value in Federal and Indian leases. Let us assume for purposes of argument that that is the case. In the Indian leases, because there are varying valuation methods described in the Indian leases as may also be described in the Federal leases, we have been litigating for the past 5 years on what value method is required to be selected by the Secretary of the Interior.

Because of the trust responsibility which extends only to the Indian lessors, the courts have held that of those available methods described in the lease terms and the regulations and NTL-5, the Secretary of the Interior must select that method which yields the greatest tribal royalties in interpreting the Indian mineral leasing acts whose legislative history make absolutely clear that the trust responsibility requires the Secretary to maximize Indian royalty returns from their resources. That is the governing law of this Congress, and that is what the courts have interpreted uniquely in the Indian lease context.

Senator MELCHER. I am fully aware of that, counsel.

The question is what does the term "value" mean. And 211.13 in CFR says: "Value for the purposes of the lease may in the discretion of the Secretary of the Interior be calculated on the basis of the highest price paid or offered or calculated on the basis of short

or actual volume at the time of production for the major portion of the oil," and it goes on, "or hydrocarbons," or whatever, "from the field where the leased lands are situated. The actual amount realized by the lessee from the sale of such products may in the discretion of the Secretary of the Interior be deemed mere evidence of a conclusive evidence of such value."

Now, I recognized at the start of this that the trust responsibility—and that is where it is at.

Ms. WILLIAMS. That's correct.

Senator MELCHER. We do not need to kid ourselves—that the trust responsibility may put the tribes in a different position than the Federal Government or the states. If you choose to litigate—and you have chosen to litigate. Both tribes? Both tribes are litigating now?

Ms. WILLIAMS. Shoshone and Arapahoe are litigating.

Senator MELCHER. Shoshone and Arapahoe are, but Southern Utes are not?

Mr. SHIPPS. Not on this issue.

Senator MELCHER. Whatever you choose to do, you may find different answers in the court. As you well know, it is time-consuming and costly.

I do not think you are going to get much out of the companies. I think what you are going to attack is the trust responsibility of the Secretary.

So, whatever. I think it would serve everybody's purposes if you could come up with a value. I am not really impressed with taking the highest price possible and then saying, well, that's what the royalty ought to be based on. I think that is one where you're probably avoiding the inevitable even in the court.

I don't know what the Department has estimated that the total for all the tribes might be—$8½ million. They may be right, close to being right. They may be way off. But I think it serves everybody's if you did see what you thought you were out and it might be the basis of settlement rather than going to court.

We will probably have to do something here in this committee to resolve this quickly. States seem to have been reaching the conclusion rather rapidly. It might be wise for individual tribes to reach a conclusion rather rapidly too because I do not think we can wait very long. You can still go to court and litigate under it, but I do not think we have got long to wait here. And we are going to have to be sure that this thing is put to bed completely very quickly as far as the Department of the Interior's ongoing, day-to-day activities are concerned.

I well understand the protection the tribes have on their trust responsibility, and you may be able to make the case and win a case and collect some money, but I do not think you are going to get it out of the—I do not think you are going to get a royalty higher out of the companies than what an arm's length, actual transaction was at the time.

I am going to ask the Arapahoe and Shoshone. Under no circumstances did you say to somebody, the gas is too cheap now. Let's cut down production or cut it off for a while.

Mr. ASAVITO. Senator, if I may respond to that. We do have some of our more recent leases that were entered into in the early 1980s

that provide for a shut-in gas well clause. And Exxon for one did shut in a couple of their wells on the reservation pursuant to that clause.

Senator MELCHER. At the tribe's request?

Mr. ASAVITO. At Exxon's and the tribe's—it was a joint decision.

Senator MELCHER. It was a joint decision.

Mr. ASAVITO. That is correct.

Senator MELCHER. All right.

Ms. WILLIAMS. Mr. Chairman, just a——

Senator MELCHER. I understand the other parts—the older leases that you couldn't actually do that.

Ms. WILLIAMS. Correct.

Senator MELCHER. But you could ask them anyway.

Ms. WILLIAMS. If I could just make one quick point, Mr. Chairman.

Senator MELCHER. Yes.

Ms. WILLIAMS. Thank you.

As to whether or not the companies can pay, it is our position that some companies may not be able to pay, and we recognize that possible contingency. But there are some companies out there that can afford to pay the royalties due. The real question ought to be placed in the proper context and that is, can the tribes afford not to be paid. In light of the high unemployment on the reservations, Mr. Chairman, we submit that the question ought to be can the Indian tribes afford not to be paid what was due and owing them.

Thank you.

Senator MELCHER. I recognize that. That is a side issue though. And that is what motivates the tribes to go to court to get it. I understand that, but that is not what—you are not saying the courts are going to decide on that basis. They are going to decide on the basis of law and regulations, are they not?

Ms. WILLIAMS. But the companies that are before you here today are saying on the equities extraordinary retroactive rulemaking ought to be applied because they cannot afford to pay. We are saying the equities weigh in our favor because we cannot afford not to be paid.

Senator MELCHER. You better go to court on that one.

Ms. WILLIAMS. We hope we do not have to.

Senator MELCHER. Pardon me?

Ms. WILLIAMS. We hope we do not have to.

Senator MELCHER. Well, I think you better on that point. You are coming on awfully strong and just blanketing all companies that have come here today I guess and saying that they can afford to pay. We have only had three or four witnesses, and they represent an awful lot of independents that I know would not have that kind of money. And I do not know where they would ever get it.

Ms. WILLIAMS. Tribes are willing to work out arrangements with them. The oil and gas prices are on the rebound. We have new exploration and production on our reservations.

Senator MELCHER. Well, on that point you go to court. I do not think we can resolve that one for you. But what we can resolve is what happens to the Department of the Interior who has moved forward with a regulation at one point saying that this is in compliance with the basic law and other basic regulations, and then

flip-flopped on it at another point and saying it would not be fair. It could not be done that way. It could not be implemented that way.

What we are in business here in this committee is to make sure that Department of Interior is functioning. On the basis of what we looked at over the past year, we do not think they are functioning on this point. There are some other points too. But on this particular point, we think they are in never-never land. And we think our responsibility as a committee is to make sure that they are functioning.

On the question of whether or not you can collect on behalf of the tribe a greater royalty based on a different value than what was actually received at the wellhead at the time, you are saying that it was not an arm's length transaction and that there is more value there than was identified on that basis. That is a different thing. We cannot do that for you in this committee.

What we are going to do to encourage I think possibly—and that is why I mentioned this to you. Possibly the committee may want to encourage the Department of the Interior to resolve this with tribes quickly and avoid the litigation which in your case you are already into, and the Southern Utes might well be into it, and other tribes may be into it. If that were going to be done, I guess there would have to be a meeting of the minds between the tribes and the Secretary. And we might be in favor that kind of a solution for the tribes.

All right. I want to thank you all very much.

Mr. ASAVITO. Thank you, Mr. Chairman.

Mr. SHIPPS. Thank you, Mr. Chairman.

Mr. COLLINS. Thank you.

Ms. WILLIAMS. Thank you.

Senator MELCHER. All right.

The Interstate Oil Compact Commission has requested that a letter on the NTL–5 position adopted by six western governors earlier this week be made part of the record. And I will make part of the record immediately after opening statements made by Senators. We referred to it. All of us referred to it in our discussion. So, we will have it right at the start of our hearing this morning.

The subcommittee record will be kept open for 2 weeks.

Thank you all very much.

[Whereupon, at 1:13 p.m., the hearing was adjourned.]

APPENDIX

Responses to Additional Committee Questions From the Department of the Interior

SUBCOMMITTEE ON MINERAL RESOURCES DEVELOPMENT AND PRODUCTION
OVERSIGHT HEARING ON NTL-5
July 10, 1987

ADDITIONAL QUESTIONS FROM SENATOR MELCHER
TO THE DEPARTMENT OF THE INTERIOR

1. Question: What are your views on the NTL-5 position approved by six Western Governors on July 6, 1987?

   - How would MMS implement the case-by-case review for granting relief from NTL-5, as suggested by the Governor's position paper?

   - What protections could MMS put in place, as suggested by the Governors, to avoid determining value based on verbal agreements, retroactive contracts, non-arms-length contracts or other considerations apart from legitimate market conditions?

   Answer: As the Committee is aware, MMS and representatives of six western States recently developed a mutually acceptable approach regarding the enforcement of NTL-5 prior to August 1, 1986. Subsequently, a similar arrangement was negotiated with representatives of several tribes and allottee groups. Documents which describe valuation procedures which would be used if these proposals were ratified, plus a proposed draft of legislative language which would be needed to implement the provisions, are included as Attachments 1 and 2.

2. Question: In what situations, in addition to those where legitimate market-out rights have been exercised, do you think relief from NTL-5 needs to be granted retroactively?

   Answer: Additional situations where the application of NTL-5 may yield an unreasonable result include gas that was released from long-term contracts and sold under a pipeline's special marketing programs, gas that was sold on the spot market at less than the NGPA maximum lawful price, and gas sold under a new or renegotiated contract at prices below NGPA maximum lawful prices.

3. Question: Of the revenues that have already been paid to the Indians, how much has gone to the Tribes and how much to allottees?

   - How many allottees could be affected?

   Answer: Of NTL-5 amounts collected and distributed, MMS estimates that $83,000 has already been distributed to Indians, with $50,000 going to tribes and $33,000 going to allottees.

   The Bureau of Indian Affairs estimates that payments to 8,420 allottees could be affected by NTL-5.

4. Question: Of the royalties potentially collectable under NTL-5, how much would be paid to the Tribes and how much to allottees?

Answer: MMS estimates that enforcement of NTL-5 during the 1982-1986 period could result in addition billings of $8.7 million on Indian leases. Approximately $6.0 million would be attributable to tribal leases, and $2.7 million to allotted leases.

It should be noted that any orders to pay additional royalties based on NTL-5 application would be appealed and litigated by lessees. Final judicial resolution would almost certainly yield payments less than the amounts "potentially collectible."

5. Question: Is it the view of the Department of the Interior that there is a legal rationale for treating Indian leases differently from federal leases with respect to a retroactive modification of NTL-5?

° If so, what is the legal rationale?

Answer: As discussed in the answer to Question 1, MMS and Indian representatives have developed a mutually acceptable approach to the enforcement of NTL-5 before August 1, 1986. If this agreement is ratified, MMS will not pursue a rulemaking to retroactively modify NTL-5.

6. Question: MMS has provided estimates on the amounts of money involved in this matter. These estimates have been revised by MMS several times.

° How accurate are the current estimates?

° Could MMS take additional steps to give us a more accurate estimate of the amounts involved?

Answer: MMS has provided two types of estimates of the amounts of money involved.

a. Amount of royalty potentially collectible under NTL-5. MMS estimates that a maximum of approximately $134.5 million is possibly at issue, with about $125.8 million of that amount applying to Federal leases and about $8.8 million to Indian leases. These amounts represent the estimated royalty differential calculated on the basis of NGPA maximum lawful prices, reached by strict adherence to current NTL-5 requirements, and natural gas prices, usually representing sales proceeds, upon which royalties were actually reported and paid. In practice, the amount actually at issue could be less because our valuation standards can result in royalties being based on amounts in excess of sales proceeds. This estimate was originally completed in December 1986, and updated once on March 2, 1987. The details of this estimate are provided in Attachment 3.

As discussed in the answer to Question 4, orders to pay additional royalties on the basis of NTL-5 would be appealed and litigated, and payment eventually made would be affected by judicial resolution of the issues.

b. Amount of additional royalty actually collected under NTL-5 and potentially refundable. MMS has concluded that few if any companies paid royalties based on NGPA maximum lawful ceiling prices once their contracts were marketed-out, except for those that did so as the result of audits. The additional royalties that have been collected as a result of audits that are currently under appeal is approximately $500,000. Some additional royalties have been collected as a result of audits that are not under appeal; this amount is unknown but we believe it to be smaller than the amount under appeal. In addition, late payment interest was computed and billed whenever additional royalties were collected as a result of an audit, but the amount of this interest would be relatively small.

7. Question: What legal basis does the Department have for making a retroactive rule change in this instance?

Answer: MMS has stated that it will not issue a regulation which will cancel NTL-5 retroactively if Congress ratifies the proposed NTL-5 enforcement strategy. However, we do believe that a retroactive modification would be legal, based on a memorandum from the Associate Solicitor, Energy and Resources (Attachment 4).

8. Question: From a legal standpoint, is it the Department's position that the States and the Tribes and allottees have vested rights to funds already paid to them under NTL-5?

- Do they have vested rights to funds potentially payable to them under NTL-5?

- Please provide a brief legal analysis in response to both the above questions.

Answer: The States are entitled to a percentage of royalty revenues received by the United States from Federal leases within their respective States. See 30 U.S.C. 191. The United States royalty revenue is based on the applicable regulations. If in a given case a value required under NTL-5 is later adjusted or found to be unreasonable, then any excess revenues which the United States must refund as a consequence would correspondingly reduce the States' share.

Similarly, the Indian lessors' royalty rights are defined by the terms of their leases, which generally incorporate or reference the Department's regulations for value determination. If a later adjustment to an earlier NTL-5-required value results in a refund, then any excess revenues previously paid under NTL-5 would not be due and owing under the terms of the lease and would be subject to refund or recoupment.

Therefore, neither the States nor the tribes and allottes have a "vested right" in a property or constitutional sense to funds already paid under NTL-5 or to funds which otherwise may be "potentially payable" under that rule.

9. Question: If MMS makes its proposed rule final, thus retroactively modifying NTL-5, how will value be determined on Federal leases?

° What standards will be applied under 30 CFR 206.103?

° How will value be determined on Indian leases?

° Will the regulations found in Title 25 of the Code of Federal Regulations be controlling? If so, what standards will be applied?

Answer: If NTL-5 were modified to provide for retroactive effective dates those dates would vary depending on the NGPA maximum lawful price category of the gas to be valued. The modification to NTL-5 would not be effective until the date the gas became subject to market-out price reductions. After the effective date of modification, gas would be valued in accordance with the provisions of 30 CFR 206.

Under 30 CFR § 206.103, MMS has the flexibility to use a number of factors to establish value for royalty purposes. These are: (1) the highest price paid for a part or majority of like-quality production; (2) prices received by the lessee; (3) posted prices; and (4) other relevant matters. The regulation provides that in the absence of good reason to the contrary, the highest price paid for a majority of like-quality production in the same field or area would be considered a reasonable value. However, the value for royalty purposes cannot, by regulation, be less than the gross proceeds accruing to the lessee.

Title 30 CFR § 206.103 applies to both Federal and Indian leases, the only exception being those instances where Indian lease terms are inconsistent with the regulation. In that case, the lease terms prevail to the extent of the inconsistency.

Pursuant to the regulations at 30 CFR § 206.103 the lessee would be expected to value production for royalty purposes at its gross proceeds or the highest price being paid for a majority of like-quality production in the same field or area--unless it could provide convincing reasons why that majority price should not be considered a reasonable value for the gas. If the highest majority price determination is infeasible MMS will normally accept the gross proceeds received by the lessee under its arm's-length contract. If there is no arm's-length contract MMS normally will accept the gross proceeds received by the lessee under its non-arm's-length contract if that contract provides for payment at prices which are comparable to those paid under arm's-length contract for like-quality production from the same field or area.

QUESTIONS FROM SENATOR DON NICKLES
FOR THE MINERALS MANAGEMENT SERVICE
July 13, 1987

1. Question: Will your NTL-5 final regulations provide for a case-by-case review of the appropriate royalty value, even for dates prior to 1982?

   Answer: Final regulations modifying NTL-5 have not been drafted because of our assumption that the approach to NTL-5 enforcement jointly developed with States and with Indian representatives will yield the best solution.

2. Question: What were the remedies available to producers during this period (1982 - 1986) to protect their rights with respect to the lack of reasonableness of the FERC ceiling price as a royalty valuation standard. Was reliance on MMS correspondence "prudent" with respect to protecting their rights, or should producers have also filed for an exception under Section 1B (redetermination) in the NTL-5 regulations.

   Answer: Any lessee subject to an adverse valuation decision under NTL-5 could file an administrative appeal of the valuation decision to the Director, MMS, and then to the Interior Board of Land Appeals. Once the administrative appeals process was exhausted, the lessee could seek judicial review. If the royalty and operational costs to the lessee prevented the lease from being operated successfully, the lessee could make application for a reduction in the lease royalty rate.

   Section 1.B. of NTL-5 was not intended as a royalty payment relief provision. It was to be used by MMS to redetermine values when necessary to conform with any subsequent Federal Energy Regulatory Commission (FERC) actions. This section was intended to be used in raising values, not lowering them.

3. Question: Are you considering issuing separate regulations for the Indian royalty questions. It appears from Friday's hearing that there may be some Indian tribes that will litigate no matter what you do. Accordingly, can you issue your regulation in such a way as to keep that litigation from staying the Federal lands NTL-5 corrections?

   Answer: MMS has considered a separate rulemaking for Indian leases. We cannot say whether a rule change which affects only Federal leases could be stayed by litigation regarding Indian leases.

4. Question: Do you have the statutory authority to predicate application of the prospective royalty valuation regulations on agreements to not accept refunds?

   Answer: NTL-5 was modified effectively August 1, 1986, so it has no effect on royalty obligations incurred since that time. We know of no

way to keep a lessee from applying for or receiving a refund to which he/she is entitled.

5. Question: What are the Indian severance tax rates for the Indian leases? How is the value of oil and gas determined for these severance taxes? How does that differ from the old NTL-5 valuation? Is the NTL-5 correction similar to the severance tax valuation methodology.

Answer: Indian tribes may require the payment of severance taxes on minerals extracted from their leases. The rates and valuation basis are set by each tribe, vary by tribe, and often are modeled after similar provisions in State law.

Since MMS does not collect tribal severance taxes, we are unable to determine whether the valuation basis is similar to NTL-5 methodology, or whether it resembles the gross proceeds and median value methodologies described in the proposed approach.

6. Question: Do Indian leases contain references to FERC ceiling prices for product valuation?

Answer: No. Indian leases generally require value to be calculated on the basis of the lease's proceeds or the highest price paid or offered for the major portion of the oil or gas produced and sold from the field where the leased lands are situated. Regulations referenced by the lease document may include regulated prices as a criteria to be considered.

7. Question: Does MMS seek any further legislative delay in the effective date of the NTL-5 corrections, or the oil and gas product valuation regulations?

Answer: MMS does not seek any legislation to further delay either NTL-5 or the oil and gas valuation regulations.

8. Question: In your response to Senator Melcher's question, you stated that application of NTL-5 was not reasonable within the meaning of 30 CFR § 206.103. Could you elaborate?

Answer: The regulations found at 30 CFR § 206.103 require the Secretary to establish a "reasonable" value for production. This is accomplished by using various factors, all of which relate to market prices paid for like-quality production in the same field or area during the month of production. For some categories of gas, NTL-5 required a royalty payment valued on the higher of the NGPA maximum lawful ceiling price or the lessee's contract price. This resulted in royalty values for some lessees that was two to three times the price the lessee actually received, which we believe to be unreasonable.

Federal lease terms, as well as case law construing royalty obligations on Federal and Indian leases, require that royalty values be reasonable.

9. Question: Are the Indian tribes' attorneys fees in NTL-5 litigation reimbursed by the federal government?

Answer: We are not aware of any NTL-5 litigation currently underway. Tribal attorney fees for this purpose would not normally be a Government expense.

10. Question: Please explain your interpretation of NTL-5 (issued in 1977) is affected by the Jicarilla v. Supron decision.

Answer: In Jicarilla v. Supron, the Department was successful in its argument that the lease terms at issue in the case required the lessee to pay royalties at the higher of two valuation methodologies called for in the leases and regulations. The Tenth Circuit en banc decision, which adopted Judge Seymour's dissent, must be read in that context. Even if this decision were to be construed to require MMS to select a royalty value, based upon a reasonable interpretation of the lease terms and the regulations, which "yields to the to be the greatest royalties," or "guarantees to Indian Tribes maximum royalties," MMS continues to believe that any such royalty value must be "reasonable." Therefore, to the extent that NTL-5 requires an unreasonably high royalty value in any specific case, its enforceability is questionable.

11. Question: Does a "majority portion analysis" change the MMS position that FERC ceiling prices can still be unreasonable where the FERC ceiling price is higher than the price received by the majority of the producers in a field?

Answer: No. A major portion analysis is performed using prices actually paid during the month of production. A price resulting from such a major portion analysis may still be only one-third to one-half of FERC maximum lawful prices.

Attachment 1

MATERIALS GENERATED IN MEETING

WITH STATE REPRESENTATIVES

Resolution of NTL-5 Issue

Background

Notice to Lessees No. 5 (NTL-5) is the regulation which prescribes the procedures to be used to determine the value, for royalty purposes, of natural gas production from onshore Federal and Indian oil and gas leases. NTL-5 was promulgated in 1977 and provided that the value of production for the purpose of computing royalty for natural gas sold into interstate commerce shall be the higher of (a) the price received by the lessee or (b) the highest applicable ceiling rate then established by the Federal Power Commission (FPC) for the same vintage gas. When NTL-5 was adopted in 1977, an energy crisis existed and expectations were that gas prices would continue to rise, limited only by the FPC.

In 1978, the Natural Gas Policy Act (NGPA) was enacted which established an incentive pricing mechanism which was dramatically different from the traditional cost-based methodology used by the FPC to establish just and reasonable ceiling rates under the Natural Gas Act of 1938. The NGPA substituted an incentive pricing scheme that established, for eight basic categories of gas, a base price plus a monthly escalator according to a statutory formula. The NGPA established a maximum lawful ceiling price, but did not require purchasers to pay this maximum lawful ceiling price. In terms of royalty valuation under NTL-5, the ceiling rate established by the FPC has been interpreted to mean the maximum lawful ceiling price established by the NGPA. This was an appropriate interpretation for some time after passage of the NGPA since a strong energy market existed and natural gas, for the most part, was selling at maximum lawful ceiling prices.

However, beginning in 1982, oil prices began to erode. As the price of oil declined, so did the price of the fuels that were alternatives to oil. End users began to switch to the cheaper alternative fuels. To retain the end markets, resale prices for gas were reduced by interstate pipelines. Competition for end users necessitated reduction of wellhead purchase prices by purchasers, generally through the exercise of market out contract provisions to levels below NGPA maximum lawful ceiling levels. Also, increasing volumes of production began to be sold by producers through special marketing programs and the spot market at prices substantially below the NGPA ceiling prices. In addition, the FERC opened interstate pipelines for contract carriage of natural gas to end users. Not only did the economics in the gas industry change dramatically, but also the traditional approaches to sale and delivery of production.

The effect of this precipitous fall in natural gas market prices from NGPA maximum lawful levels can not be accomodated within the requirements of the ceiling prices of NTL-5 and still be consistent with the requirement of 30 CFR part 206 and most court

interpretations of value under the Mineral Lands Leasing Act that the value of production shall be a reasonable value. Because of this inflexibility in the valuation provisions of NTL-5, we believe a procedure should be permitted whereby the Minerals Management Service determines that, if the value of production prescribed by NTL-5 is unreasonable, the MMS shall determine a value by applying the criteria laid out in 30 CFR part 206.

30 CFR 206.103 Value basis for computing royalties.

> The value of production, for the purpose of computing royalty, shall be the estimated reasonable value of the product as determined by the Associate Director due consideration being given to the highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessee, to posted prices, and to other relevant matters. Under no circumstances shall the value of production of any of said substances for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof or less than the value computed on such reasonable unit value as shall have been determined by the Secretary. In the absence of good reason to the contrary, value computed on the basis of the highest price per barrel, thousand cubic feet, or gallon paid or offered at the time of production in a fair and open market for the major portion of like-quality oil, gas, or other products produced and sold from the field or area where the leased lands are situated will be considered to be a reasonable value.

AGREEMENT WITH STATES FOR FEDERAL ONSHORE LEASES

General Policy Parameters

1. MMS will not issue a regulation which would cancel NTL-5 retroactively.

2. MMS in consultation with the appropriate State, will determine on a case-by-case basis if the royalty value prescribed by NTL-5 is unreasonable. This will be done by looking at the prices generally received in the field or area by producers with arm's-length contracts.

3. Prices received under arm's-length contracts which are less than maximum lawful ceiling prices will generally lead to the conclusion that NTL-5 is unreasonable. Prices received under the arm's-length contract will be accepted as value, except where factors other than legitimate market conditions have influenced price.

4. In determining prices under arm's-length contracts, no verbal agreements will be accepted. If the contract has a market out clause, the new price will be effective from the date the market out clause was exercised in writing consistent with the terms of the contract. Exercise of a market out clause will not be accepted retroactively. Where the amended price is not the result of a market out clause, MMS will recognize the effective date mutually accepted in a written contract amendment. Such date will not be earlier than the date of the first written notice of intent to change price.

5. The value prescribed by NTL-5 for sales of natural gas under non-arm's-length contracts will be determined to be unreasonable if the value determined by a major portion analysis or the value determined by looking at prices received by other producers under arm's-length contracts in the same field or area is less than the maximum lawful ceiling price. If the maximum lawful ceiling price is unreasonable, value will be determined by a major portion analysis. If this is not feasible, value will be determined by looking at prices received by other producers under arm's-length contracts in the same field or area.

6. The value of production for calculating royalty shall never be less than the gross proceeds accruing to the lessee.

Implementation Procedures

Any reference in these provisions to NTL-5 is a reference to the ceiling price requirement of section I.A.2.

The principal people who will conduct the case-by-case review are the State auditors under delegations of authority under Section 205 of the Federal Oil and Gas Royalty Management Act and the MMS auditors. The MMS, however, will send out a general letter to royalty payors telling them that if they have not paid royalties pursuant to the requirements of NTL-5 that they will bear the responsibility of justifying the events or conditions which support payments on amounts less than the maximum lawful ceiling price. The general notice will state that the MMS will pursue NTL-5 valuation under audit unless the lessee can demonstrate that the value prescribed by the terms of NTL-5 is unreasonable. Unreasonable will be defined by the above general policy parameters. The MMS will also notify lessees that the audits will soon be initiated and that they shall retain all records until the audits are complete or they are further notified by MMS that record retention is no longer required.

The MMS, through the Royalty Compliance Division, will cooperatively work with State and Indian auditors to develop the requisite data and company records to perform the required case-by-case analysis.

Royalty demand letters which are based on NTL-5 and are currently under administrative appeal will be remanded to the Royalty Management Program to determine value by the above policy.

Any amount that has already been paid in accordance with NTL-5 and distributed but which is determined not to be owed will be proposed to the Congress to be refunded out of the Federal share of mineral receipts under the Mineral Lands Leasing Act.

Any amounts paid in accordance with NTL-5 but not appealed will be reviewed according to the above policy upon the request of the lessee and any amounts deemed not to be owed will be proposed to the Congress to be refunded out of the Federal share of mineral receipts under the Mineral Lands Leasing Act.

DRAFT LEGISLATIVE LANGUAGE

(for discussion purposes only)

The Minerals Management Service (MMS) shall not expend any funds appropriated under this Act for the purpose of retroactively modifying Notice to Lessees and Operators No. 5 (NTL-5), 42 Fed. Reg. 22,610 (May 4, 1977), for any period prior to August 1, 1986. If during Fiscal Year 1987 or any subsequent fiscal year the Director of MMS or his designee examines royalty valuation for any onshore natural gas production prior to August 1, 1986, the Director or his designee shall review the value required under NTL-5 to determine if such value is reasonable. If the Director or his designee determines that the royalty valuation required under NTL-5 in any particular case or category of cases is unreasonable, then such production shall be valued according to existing regulations at 30 C.F.R. Part 206, and in the case of Indian leases 25 C.F.R. 211.13 or 25 C.F.R. 212.16, as applicable, and not under NTL-5. If MMS refunds any royalties previously paid pursuant to NTL-5 as a result of a determination that the value required under NTL-5 was unreasonable, such refunds shall be paid from monies received under section 35 of the Mineral Lands Leasing Act of 1920, as amended, 30 U.S.C. 191, which would otherwise be deposited to miscellaneous receipts at the Treasury. The MMS shall not recoup any portion of any such refund from any future disbursements of royalties to a State, Indian tribe, or Indian allottee.

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NOTICE TO LESSEES AND OPERATORS NO. 5 (NTL-5)
MEETING WITH STATE REPRESENTATIVES
JULY 15, 1987
Denver, Colorado

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Bismarck, North Dakota 58505

Ms. Ruth Ann Storey
State of Utah
Administrator Assistant
210 State Capitol
Salt Lake City, Utah 84114

Mr. George Bowman
State of Utah
Utah State Tax Commission
Heber M. Wells Office Building
160 E. 300 South
Salt Lake City, Utah 84134

Ms. Nancy Fruedenthal
State of Wyoming
c/o Governor's Office
State Capitol
Cheyenne, Wyoming 82002

Mr. Roy Jones
House Interior Committee

Mr. Bill Shafer
House Interior Committee

Mr. James Cason
Department of Interior

Mr. Gary Bennethum
Department of Interior

Mr. Peter Schaumberg
Department of Interior

Mr. Bill Bettenberg
Minerals Management Service

Mr. Don Sant
Minerals Management Service

Mr. Jimmy Mayberry
Royalty Management Program

Mr. Ken Moyers
Royalty Management Program

Mr. Milton Dial
Royalty Management Program

Attachment 2

MATERIALS GENERATED IN MEETING

WITH INDIAN CONSTITUENTS

AGREEMENTS WITH INDIANS FOR INDIAN LEASES

PROCEDURES FOR VALUING INDIAN LEASES

General Policy Parameters

1 - MMS will not issue a regulation which would cancel NTL-5 retroactively.

2 - These procedures apply only to gas production subject to valuation under NTL-5 section I.A.2 where the price received for natural gas is below NGPA ceilings due to market conditions. Any reference herein to NTL-5 is a reference only to this situation.

3 - MMS will determine on a case-by-case basis if the royalty value prescribed by NTL-5 is unreasonable.

For arm's-length[1/] contract situations this will be done by ascertaining the applicable NTL-5 price, the median value[2/] and gross proceeds. Where the NTL-5 value exceeds the highest reasonable royalty value, it will be deemed to be unreasonable. Generally, MMS will conclude that NTL-5 is unreasonable where the maximum lawful ceiling price exceeds both gross proceeds and values determined by median value analysis. The MMS will be expected to pursue payment of only the highest reasonable royalty value from lessees.

If it is determined that the NTL-5 value is unreasonable, then the following procedure consistent with the requirements of the various Indian mineral leasing statutes, lease terms, and regulations in Titles

25 and 30 of the Code of Federal Regulations will be used to determine a reasonable value for gas sold pursuant to an arm's-length contract:

a. MMS will compare the gross proceeds accruing to the lessee with the median value. Median value on production will be calculated by using the like NGPA category gas of similar quality sold from the same field or area for each month. All known gas in the appropriate NGPA category will be arrayed from most expensive to least expensive. Median value is that price at which 50 percent (by volume) plus 1 mcf of the gas is sold.

b. If the median value exceeds the gross proceeds, MMS will send to the lessee an issue letter proposing to use the median value. The lessee then will be given the opportunity to rebut the proposed values, if gross proceeds is not used, by demonstrating that its arm's-length contract price was reasonably and prudently negotiated under the market circumstances existing at the time.

c. Based upon the lessee's response, MMS will make a tentative value determination. MMS will consult, if possible, with the affected Indian lessor who will have an opportunity to comment on the valuation determination.

d. If the Indian lessor and MMS agree upon the value, MMS will issue a demand letter to the lessee in accordance with the agreement. If

there is no agreement, MMS will consider all relevant matters and issue a demand letter. If that decision is adverse to the Indian lessor's position, the Indian lessor may appeal that determination.

4 - In determining prices under arm's-length contracts, no verbal agreements will be accepted. If the contract has a market out clause, the new price will be effective from the date the market out clause was exercised in writing consistent with the terms of the contract. Exercise of a market out clause will not be accepted retroactively. Where the amended price is not the result of a market out clause, MMS will recognize the effective date mutually accepted in a written contract amendment. Such date will not be earlier than the date of the first written notice of intent to change price.

5 - The value prescribed by NTL-5 for sales of natural gas under non-arm's-length contracts will be determined to be unreasonable if the value determined by a median value analysis or the value determined by looking at prices received by other producers under arm's-length contracts in the same field or area is less than the maximum lawful ceiling price. If the maximum lawful ceiling price is unreasonable, value will be determined by a median value analysis. If this is not feasible, value will be determined by looking at prices received by other producers under arm's-length contracts in the same field or area.

6 - The value of production for calculating royalty shall never be less than the gross proceeds accruing to the lessee.

7 - Upon request, MMS will be prepared to report the difference between an NTL-5 value determination and highest reasonable royalty value to the Indian tribe for their information.

1/ Arm's-length contract means a contract or agreement between independent, nonaffiliated parties which reflected the total consideration actually transferred directly or indirectly from the buyer to the seller for the gas, residue gas or gas plant products. For purposes of this Subpart, two persons are affiliated if one person controls, is controlled by, or is under common control with another person. For purposes of this section, based on the instruments of ownership of the voting securities of an entity, or based on any other forms of ownership:

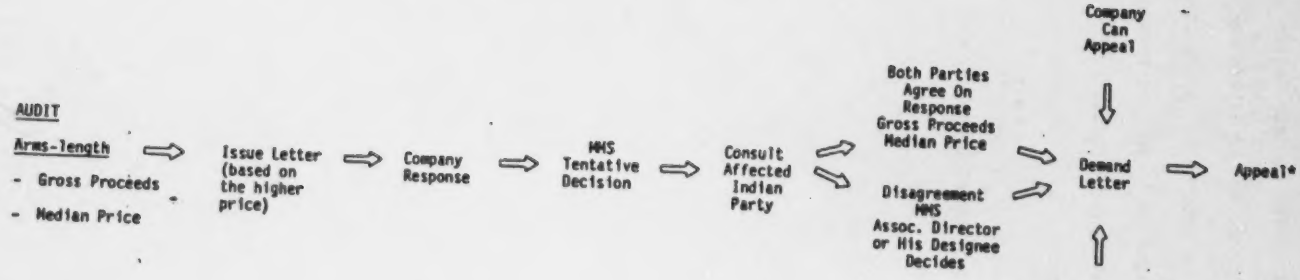
(1) Ownership in excess of 50 percent constitutes control;

(2) Ownership of 20 through 50 percent creates a presumption of control; and

(3) Ownership of less than 20 percent creates a presumption of noncontrol.

Notwithstanding any provisions of this section, contracts between relatives, either by blood or by marriage, are not arm's-length contracts. The MMS may require the lessee to certify ownership control. To be considered arm's-length for a specific month the requirements of this section must be met for that production month as well as when the contract was executed.

2/ Where median value is used herein, it is intended to mean median value as typically conducted by MMS, or where such value cannot be determined, a value based on a comparable value analysis or a value determined by any other appropriate method. MMS recognizes that litigation is pending regarding a weighted average approach. Nothing in this agreement prejudices the litigation position of the various parties to that suit, and MMS recognizes that for the periods at issue, the result of that litigation may require MMS to revisit the audits based on the weighted average approach.



*Company and Indian appeals will be handled as required by 30 CFR 290.

DRAFT LEGISLATIVE LANGUAGE

(for discussions purposes only)

The Minerals Management Service (MMS) shall not expend any funds appropriated under this Act for the purpose of retroactively modifying Notice to Lessees and Operators No. 5 (NTL-5), 42 Fed. Reg. 22,610 (May 4, 1977), for any period prior to August 1, 1986. If during Fiscal Year 1987 or any subsequent fiscal year the Director of MMS or his designee examines royalty valuation for any onshore natural gas production prior to August 1, 1986, the Director or his designee shall review the value required under NTL-5 to determine if such value is reasonable. If the Director or his designee determines that the royalty valuation required under NTL-5 in any particular case or category of cases is unreasonable, then such production shall be valued according to existing regulations at 30 C.F.R. Part 206, and in the case of Indian leases 25 C.F.R. 211.13 or 25 C.F.R. 212.16, as applicable, and not under NTL-5. If MMS refunds any royalties previously paid pursuant to NTL-5 as a result of a determination that the value required under NTL-5 was unreasonable, such refunds shall be paid from monies received under section 35 of the Mineral Lands Leasing Act of 1920, as amended, 30 U.S.C. 191, which would otherwise be deposited to miscellaneous receipts at the Treasury. The MMS shall not recoup any portion of any such refund from any future disbursements of royalties to a State, Indian tribe, or Indian allottee.

NOTICE TO LESSEES AND OPERATORS NO. 5 (NTL-5)
MEETINGS WITH INDIAN COMMUNITY REPRESENTATIVES
July 16, 23, & 24, 1987*
Denver, Colorado

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Mr. David Lester
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Mr. David Harrison
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Ms. Karen Anderson
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Ms. Vida Peabody
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Southern Ute Tribal Attorney
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* Not all participants were present at all meetings.

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Chairman, Arapahoe
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Towaoc, Colorado

Mr. John Sparks
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Mr. Roy Jones
House Interior Committee

Mr. William Shafer
House Interior Committee

Mr. Gary Bennenthum
Department of Interior

Mr. James Cason
Department of Interior

Mr. Peter Schaumberg
Department of Interior

Mr. Bill Bettenberg
Minerals Management Service

Mr. Don Sant
Minerals Management Service

Mr. Jerry Hill
Royalty Management Program

Mr. Jimmy Mayberry
Royalty Management Program

Mr. Ken Moyers
Royalty Management Program

Mr. Milton Dial
Royalty Management Program

Mr. Don Jones
Royalty Management Program

Mr. Bill Trujillo
Royalty Management Program

Mr. Pete Aguilar
BIA

Mr. Del Brewer
BIA

MEMORANDUM TO DEPUTY ASSISTANT SECRETARY -

LAND AND MINERALS MANAGEMENT

SIGNED BY TWO INDIAN REPRESENTATIVES

Memorandum

To: Jim Cason, Deputy Assistant Secretary, Land and Minerals Management

From: Indian Representatives

Subject: Proposed Retroactive Application of the Modified NTL-5

Date: July 24, 1987

We, the undersigned tribal representatives, desire that our views on the above-titled issue (and, we believe, also the views of the tribal representatives not signatories to this memorandum, but who participated in the July 23rd meetings with you in Denver and who are listed below on the signature page), be communicated to all concerned. Your cooperation is requested in ensuring this memorandum describing these views is included in the materials you transmit to Congress regarding your anticipated treatment of the above-entitled issued.

In 1977, during a period of steadily rising prices of natural gas, the MMS adopted a rule known as NTL-5 to secure for Federal, state, and Indian royalty recipients royalty payments based on the highest value permitted by the laws and regulations governing the sales prices of natural gas. Essentially, NTL-5 required lessees to pay royalty on the greater of the applicable regulated prices or the gross proceeds of sale. Beginning in 1982, the natural gas market entered a period of steadily declining prices, a period which has continued until recently. By 1986, it became apparent that NTL-5 might not be an appropriate method of valuing natural gas for royalty calculation purposes because some lessees were receiving gross proceeds far less than regulated prices. MMS, therefore modified the rule on August 1, 1986, by eliminating the strict adherence to regulated prices as a valuation benchmark.

Since 1986, MMS has received increasing evidence that, for the period of 1982-1986, to demand royalty payments based on the regulated prices stipulated by NTL-5 may result in considerable inequities in many cases for lessees who simply could not collect these prices for the gas they produced. Accordingly, in January, 1987, the MMS proposed to apply the modified NTL-5 retroactively in order to accord relief to these lessees. Vigorous opposition from states and Indian lessors has led the Congress to prohibit, temporarily at least, this attempt to modify the rule retroactively. Various members and committees of the Congress have urged the MMS, the states, and Indian lessors to attempt to reach an agreement on the manner in which this issue should be resolved. In response to these suggestions, you and the MMS have met with representatives of the affected states and Indian lessor, and have reached tentative agreements along the following lines.

With respect to the states, which receive one-half of the royalties collected from leases of Federal lands within their borders an agreement has been reached which requires a case by case review of whether the unmodified NTL-5 should be applied retroactively.

With respect to the Indian lessors, a tentative understanding has been reached which embodies the following principles:

The MMS acknowledges that the trust responsibility of the United States in the administration of Indian oil and gas properties imposes a unique and a high duty of care which requires that the royalties collected for production of gas from Indian lands be based on the highest reasonable value which can be ascribed to that production, consistent with the applicable terms of the leases and regulations. Although MMS believes that, in most instances involving arm's-length contracts, the gross proceeds received by the lessee do provide evidence of market value, the higher duty of care required in the discharge of the trust responsibility to Indian lessors requires that additional inquiry be made to ensure collection of the highest reasonable royalty value, and that inquiry does not permit an unexamined acceptance of gross proceeds even in cases involving arm's-length contracts.

In addition, to apply strictly the regulated price benchmark contained in NTL-5 to natural gas produced from Indian lands for the period 1982-1986 could result in considerable inequities for many lessees. On the other hand, to accord universal relief to all lessees by permitting them to remit royalties based on their sales proceeds very conceivably could result in similar inequities for the Indian lessors.

The MMS and representatives of the Indian lessors, therefore, have agreed that the MMS will continue the process of auditing all Indian leases from which natural gas has been produced during this period. In those instances in which royalty payments have been made on values which are significantly lower than those which would be required under a strict application of the unmodified NTL-5, the MMS will conduct a further analysis to determine the highest reasonable value upon which royalty payments would be required without reference to NTL-5. MMS then will initiate action to collect from the lessees or payors for any additional royalties revealed in this analysis.

Lessees who receive letters from MMS notifying them of additional royalty due would be given the opportunity to present to the MMS any reasons why they were unable to receive gross proceeds equal to the determined value. Acceptable reasons will be limited to purely objective market considerations. The MMS, thereafter, and following consultation with the Indian lessor, will make a decision whether or not to accept the lessee's explanations, and accordingly, to accept proceeds as value. If the MMS and the Indian lessor agree, either to accept or not to accept the lessee's gross proceeds as value, the MMS will issue a demand letter based on the agreed upon value. If the MMS and the Indian lessor cannot agree, then the MMS will make a decision in the matter, which decision both the Indian lessor and the lessee will have a right to appeal administratively.

In all instances, the differences between the determined values and the values which would have been due under a strict application of NTL-5 will be reported both to the Congress (upon request) and to the Indian lessors. The Indian lessors assert strongly that this difference should be paid to the Indian lessors by the United States. The Indian lessors advance a number of reasons for this position.

The Indian lessors maintain that, no less than the lessees who are regulated by the MMS regulations, the Indians have a right and a legitimate expectation to rely upon the the diligent and uniform enforcement of regulations until such time as they are modified through appropriate administrative processes. Indeed, the Indians argue that the Federal trust duty in respect to management of Indian gas, accords them even greater rights than lessees to certainty in the application of the rules governing valuation of their gas. As a class of people for whose benefit these regulations were promulgated, the Indians maintain that payments or rights to payment accruing to them under these regulations rise to the level of vested property rights, and cannot be taken without just compensation. They further state that, under this theory, any attempt to modify the rule retroactively would subject all parties to lengthy and expensive litigation.

The Indians are willing, however, to acquiesce in the agency's efforts to provide equitable relief to lessees in appropriate cases, but the Indian lessors believe that the costs associated with providing this relief should rest with the United States where the responsibility for the inequity lies. More specifically, the Indians emphasize, and MMS concedes, that the rule at issue in this instance, in retrospect, should have been changed much earlier than it was changed. The party responsible for making this rule change, and thus responsible for any inequities now imposed upon lessors and lessees alike by failing to change the rule, clearly is the United States.

The Indian lessors further emphasize that they relied upon the government to enforce rules that were designed, at least in part, for their benefit and protection, and that financial and budgetary decisions, and policies for the period in issue have been made in reliance upon enforcement of the rules (i.e.. the unmodified NTL-5). The Indians charge that the MMS in large part is responsible for the failure of most lessees to comply with this rule during the period in issue because the agency effectively advised such lessees informally that compliance with the rule was not necessary. The Indian lessors were neither parties to, nor were aware of, these communications until several years had passed. In their view of the law, these lessees are not legally entitled to rely upon such informal advice, even from government officials, to ignore a rule which was in force and effect at the time. The fact that such advice was communicated to these lessees, without the lessors being made aware of such communications, did have the effect of precluding these lessors from receiving the opportunity to renegotiate their lease terms, reach negotiated settlements with the lessees, or otherwise to act to protect their own interests during this time.

For these reasons, the MMS and the Indian lessors have agreed to compute the differences in royalties due to the Indian lessors as a result of providing the above-described relief to the lessees; to advise the Indian lessors and, upon request - the Congress, of those differences; to set forth the facts and circumstances surrounding this issue; and to present to the Congress the Indian lessors' reasons for insisting that these differences in proceeds should be borne by the United States. The Indian lessors suggest that these differences should be met by means of an authorization for

the expenditure of such sums as may be required to compensate the Indian lessors for the difference between the amounts they would receive under a strict application of NTL-5 and the amounts they actually receive under the terms of the agreed-upon approach as outlined above, such sums to be paid out of the Federal share of future oil and gas royalties collected for production of oil and gas from Federal lands.

Also attached hereto is proposed language for the FY 1988 appropriations bill for the Department of the Interior describing the above-described agreement. We request that MMS ensure the attached agreement is incorporated in full in the Report for the FY 1988 bill.

Council of Energy Resource Tribes

Shoshone Tribe

Attendees at the July 23rd meeting:

Ute Mountain Ute Tribe
Southern Ute Tribe
Northern Arapahoe Tribe
Oklahoma Indian Minerals Owner Association
Indian Minerals Owner Association
Cheyenne-Arapahoe Tribes
Navajo Tribe
Jicarilla Apache Tribe

Attachment 3

United States Department of the Interior
MINERALS MANAGEMENT SERVICE
ROYALTY MANAGEMENT PROGRAM
P.O. BOX 25165
DENVER, COLORADO 80225

IN REPLY REFER TO

Mail Stop 653

MMS-RVS-:MISC-003

MAR 2 1987

Memorandum

To: Chief, Royalty Liaison Office

From: Chief, Royalty Valuation and Standards Division

Subject: Revision to Estimate of Uncollected Royalties Affected by Retroactive Amendment of NTL-5

Attached is the revised estimate of potential royalty impact that would be involved should there be a retroactive amendment to Notice to Lessees and Operators of Federal and Indian Onshore Oil and Gas Leases No. 5 (NTL-5) to January 1, 1983. Only those items which have changed since the original analysis was performed are identified.

William H. Feldmiller

Attachment

Revised Estimated Impact of Retroactive Rulemaking - NTL-5

Previous Estimate

- Original estimated amount for the time period of January 1, 1983, through July 31, 1986 - $141,000,000
- Estimate of percent attributable to Indian lands - 10 percent.

Revised Assumptions

- Thirty eight percent of the gas volumes from Indian lands and 1.8 percent of the gas volumes from Federal lands used in original estimate were produced in Oklahoma. At least 50 percent of this gas is subject to communitization or unitization agreements and, therefore, to Blanchard Decision (valuation of gas not subject to NTL-5).
- Nineteen percent of the gas volumes from Indian lands used in original estimate were produced from leases on the Jicarilla Apache Indian Reservation in New Mexico. Gas volumes from these leases were not subject to NTL-5 as specified in the Federal Register on August 9, 1977.

Revised Estimate

- Of $14.1 million originally attributable to Indian lands for the period 1/1/83 through 7/31/86, 19 percent (1/2 of 38 percent) must be subtracted due to gas subject to communitization or unitization agreements in Oklahoma not being subject to NTL-5, or $2.68 million.
- Of $14.1 million, 19 percent must be subtracted due to lack of applicability of NTL-5 to gas from Jicarilla Apache Reservation, or $2.68 million.
- Of $126.9 million originally attributable to Federal lands for the period 1/1/83 through 7/31/86, .9 percent (1/2 of 1.8 percent) must be subtracted due to lack of applicability of NTL-5 to certain gas in Oklahoma, or $1.15 million.
- Revised overall estimate - $134.5 million

  Federal - $125.75 million
  Indian - $ 8.75 million

United States Department of the Interior

MINERALS MANAGEMENT SERVICE
ROYALTY MANAGEMENT PROGRAM
P.O. BOX 25165
DENVER, COLORADO 80225
Mail Stop 653

IN REPLY REFER TO:

MMS-RVS-OGV:86-0832

Memorandum

To: Chief Royalty Liaison Office

From: Chief, Royalty Valuation and Standards Division

Subject: Estimate of Uncollected Royalties Affected by Retroactive Amendment of NTL-5

Enclosed is the estimate of potential royalty impact that would be involved should there be a retroactive amendment to NTL-5 to either January 1, 1983 or March 1, 1984. This was prepared by John Price and the Branch of Oil and Gas Valuation at the request of the Director's Office.

William H. Feldmiller

cc: Associate Director for Royalty Management

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OVERVIEW

Estimate of Potential Total Uncollected Royalties -- NTL-5 Required Value Versus Probable Gross Proceeds Per Lessee's Contract

Prepared by: Minerals Management Service, Royalty Management Program, Lakewood, Colorado

- Estimated amount for the time period of January 1, 1983, through July 31, 1986, $141,000,000
- Estimated amount for the time period March 1, 1984 through July 1,1986, $105,000,000
- Estimate of percent attributable to Federal and Indian lands.

Indian lands	10%
Federal lands	90%

- Estimate of percent by major producing States.

New Mexico	54%
Wyoming	28%
Colorado	6%
Utah	4%

Estimated Impact Analysis of Retroactive Rulemaking - NTL-5

Overall Assumptions

Period covered - January 1983 through July 1986.

Section of NTL-5 Analyzed -
Section I.A.2., Interstate Sales of Regulated Gas, requiring valuation at NGPA maximum lawful ceiling prices.

Estimate of Gas Sold in Interstate Commerce -
Figures derived from Energy Information Administration (EIA) publications.

Estimate of Onshore Federal and Indian Gas Sold in Interstate Commerce -
Total onshore production sold in interstate commerce divided by total onshore production (interstate and intrastate) with resulting percentage applied to total onshore Federal and Indian gas production reported to MMS as sold. Assumes percentage of onshore interstate sales in the nation applies to onshore Federal and Indian gas (excludes Alaska and California which have no interstate sales of gas production).

Estimate of Onshore Federal and Indian Gas Sold by NGPA Category -
EIA publication data on national basis applied to onshore Federal and Indian gas production reported to MMS as sold (excluding Alaska and California). It was assumed that all OCS gas is sold in interstate commerce, and that OCS gas has no, or insignificant amounts of, NGPA Categories 103, 107, and 108

NGPA category 108 was not included because low volumes of this gas allowed pipelines to continue to pay NGPA prices longer than for other NGPA categories.

On January 1, 1985, NGPA Categories 103 and 107(c)(5) (tight gas sands) were partially decontrolled. Assumption was made that 50 percent of 103 and 107(c)(5) gas was deregulated as of 1/1/85.

Total estimated royalty impact based on above assumptions - $94,000,000.

One of the weakest assumptions is probably the percentage of total onshore Federal and Indian production that is sold in interstate commerce. The reason being that the States of Colorado, New Mexico and Wyoming have the majority of all onshore Federal and Indian gas production, and it is believed that about 80 percent of this production is sold in interstate commerce. When this 80 percent figure is added to 50 percent of the remaining total onshore Federal and Indian production (excluding California and Alaska), the percentage of onshore Federal and Indian production sold in interstate commerce approaches 75 percent. Therefore, the $94,000,000 is only two thirds of the probable impact.

$94,000,000 x 3/2 = $141,000,000.

For a retroactive date of March 1, 1984, impact estimated by subtracting 1983 totals plus 1/6 of 1984 totals - $70,000,000, or $105,000,000 based upon 75 percent of Federal and Indian production being sold into interstate commerce.

Of these amounts, approximately 90 percent is attributable to onshore Federal lands and 10 percent is attributable to Indian lands based upon gas royalties reported to MMS.

1983

Total OCS Production - 3,940 Bcf
Percent Onshore Sold in Interstate = 50 percent
Total Federal and Indian Production, excluding Alaska and California - 1,011 Bcf.

Interstate Sales by NGPA Category - Onshore Federal and Indian Lands

NGPA	Percent of Sales	Onshore Federal and Indian Sales (Mcf)
102	21.2%	107,166,000
103	19.2%	97,056,000
104	35.3%	178,442,000
106(a)	1.9%	9,604,000
107	18.2%	92,001,000
108	3.1%	15,671,000
109	1.1%	5,560,000
	100.0%	505,560,000

NGPA Categories Affected by Market-Outs

NGPA Category	Volumes (Mcf)	Average NGPA Price	Average Market-out Price
102 (7/1/83)*	5,358,300	$3.507	$ 3.250
107(c)(5) (1/1/83)**	73,600,800	$5.567	$ 3.750

* Assumes only 10 percent of volumes in last 6 months affected.
** Represents 107(c)(5) tight gas sands only, assumed to be 80 percent of all 107 gas.

Estimated Royalty Impact - 1983

NGPA 102 - 5,358,300 Mcf x $0.250/Mcf x 1/8 = $ 167,447

NGPA 107(c)(5) - 73,600,800 Mcf x $1.817/Mcf x 1/8 = $16,716,582

$16,884,029

1984

Total OCS Production - 4,538 Bcf
Percent Onshore Sold in Interstate = 50 percent
Total Federal and Indian Production, excluding Alaska and California - 1,128 Bcf.

Interstate Sales by NGPA Category - Onshore Federal and Indian Lands

NGPA	Percent of Sales	Onshore Federal and Indian Sales (Mcf)
102	20.5%	115,620,000
103	20.7%	116,748,000
104	31.4%	177,096,000
106(a)	2.2%	12,408,000
107	19.4%	109,416,000
108	4.3	24,252,000
109	1.5%	8,460,000
	100.0%	564,000,000

NGPA Categories Affected by Market-Outs

NGPA Category	Volumes (Mcf)	Average NGPA Price	Average Market-out Price
102	115,620,000	$ 3.716	$ 3.00
107*	87,532,800	$ 5.804	$ 3.00

* Represent 107(c)(5) gas only.

Estimated Royalty Impact - 1984

NGPA 102 - 115,620,000 Mcf x $0.716/Mcf x 1/8 = $10,347,990

NGPA 107(c)(5) - 87,532,800 Mcf x $2.804/Mcf x 1/8 = $30,680,246

$41,028,236

1985

Total OCS Production - 4,001 Bcf
Percent Onshore Sold in Interstate = 50 percent
Total Federal and Indian Production, excluding Alaska and California - 1,026 Bcf.

Interstate Sales by NGPA Category - Onshore Federal and Ind'an Lands

NGPA	Percent of Sales	Onshore Federal and Indian Sales (Mcf)
102	24.3%	124,659,000
103	19.7%	101,061,000
104	31.0%	159,030,000
106(a)	3.1%	15,903,000
107	15.4%	79,002,000
108	4.3%	22,059,000
109	2.2%	11,286,000
	100.0%	513,000,000

NGPA Categories Affected by Market-Outs

NGPA Category	Volumes (Mcf)	Average NGPA Price	Average Market-out Price
103*	50,530,500	$3.257	$2.500
104**	26,239,950	$2.515	$2.250
106(a)**	2,623,995	$2.515	$2.250
107(c)(5)*	31,600,800	$6.014	$2.500
109**	5,643,000	$2.515	$2.250

* NGPA 103 and 107(c)(5) were partially decontrolled on 1/1/85. Assumes 50% of volumes deregulated, only remaining regulated volumes shown.

** Affected for last 6 months of 1985. For 104 and 106(a), subcategories affected assumed to represent 33% of total volumes in these categories.

Estimated Royalty Impact - 1985

NGPA 103	-	50,530,500 Mcf x $0.757/Mcf x 1/8	= $ 4,781,449
NGPA 104	-	26,239,950 Mcf x $0.265/Mcf x 1/8	= $ 869,198
NGPA 106(a)	-	2,623,995 Mcf x $0.265/Mcf x 1/8	= $ 86,920
NGPA 107(c)(5)	-	31,600,800 Mcf x $3.514/Mcf x 1/8	= $13,880,651
NGPA 109	-	5,643,000 Mcf x $0.265/Mcf x 1/8	= $ 186,924
			= $19,805,142

1986

Percent Onshore Sold in Interstate = 50 percent
Total Federal and Indian Production, excluding Alaska and California - 509 Bcf (through July 1986, and based upon 1985 data assuming 15 percent decline in production).

Interstate Sales by NGPA Category - Onshore Federal and Indian Lands

NGPA	Percent of Sales	Onshore Federal and Indian Sales (Mcf)
102	22.2%	56,499,000
103	23.2%	59,044,000
104	30.1%	76,605,000
106(a)	3.6%	9,162,000
107	13.4%	34,103,000
108	5.4%	13,743,000
109	2.1%	5,344,000
	100.0%	254,500,000

NGPA Categories Affected by Market-Outs

NGPA Category	Volumes (Mcf)	Average NGPA Price	Average Market-out Price
103 *	29,522,000	$3.406	$1.80
104 **	25,279,650	$2.574	$1.80
106(a) **	3,023,460	$2.574	$1.80
107(c)(5)*	13,641,200	$6.217	$1.80
109 **	5,344,000	$2.574	$1.80

* Assumes 103 and 107(c)(5) regulated volumes represent 50% of total interstate sales in these categories.

** For 104 and 106(a), subcategories affected assumed to represent 33% of total volumes in these categories.

Estimated Royalty Impact - 1986

NGPA 103	-	29,522,000 Mcf X $1.606/Mcf x 1/8	= $ 5,926,541
NGPA 104	-	25,279,650 Mcf X $0.774/Mcf x 1/8	= $ 2,445,806
NGPA 106(a)	-	3,023,460 Mcf X $0.774/Mcf x 1/8	= $ 292,520
NGPA 107(c)(5)	-	13,641,200 Mcf x $4.417/Mcf x 1/8	= $ 7,531,648
NGPA 109	-	5,344,000 Mcf x $0.774/Mcf x 1/8	= $ 517,032
			= $16,713,547

1983

Total OCS Production - 3,940 Bcf

	Total Interstate Sales (Bcf)		1-OCS%*		Total Onshore Inter-State Sales (Bcf)
102	2,496	X	.44	=	1,098
103	990			=	990
104	4,146	X	.44	=	1,824
106(a)	225	X	.44	=	99
107	942			=	942
108	160			=	160
109	127	X	.44	=	56
					5,169

	% NGPA of Total Onshore Interstate Sales	X	50% Total Onshore Federal & Indian (less Alaska & Calif.)	=	Distribution of Onshore Federal and Indian Interstate Sales (Bcf)
102	0.212			=	107.166
103	0.192			=	97.056
104	0.353			=	178.442
106(a)	0.019			=	9.604
107	0.182			=	92.001
108	0.031			=	15.671
109	0.011			=	5.560
	1.000		505.5 Bcf		505.500

* OCS does not have 103,107,108, or only has insignificant amounts.

$$1 - OCS = 1 - \frac{3,940}{2,496 + 4,146 + 225 + 127} = 1 - \frac{3,940}{6,994} = 1 - .56 = .44$$

1984

Total OCS Production - 4,538 Bcf

	Total Interstate Sales (Bcf)		1-OCS%*		Total Onshore Inter-State Sales (Bcf)
102	2,587	X	.35	=	905
103	913			=	913
104	3,961	X	.35	=	1,386
106(a)	283	X	.35	=	99
107	856			=	856
108	189			=	189
109	191	X	.35	=	67
					4,415

	% NGPA of Total Onshore Interstate Sales	X	50% Total Offshore Federal & Indian (less Alaska & Calif.)	=	Distribution of Onshore Federal and Indian Interstate Sales (Bcf)
102	0.205			=	115.620
103	0.207			=	116.748
104	0.314			=	177.096
106(a)	0.022			=	12.408
107	0.194			=	109.416
108	0.043			=	24.252
109	0.015			=	8.460
	1.000		564.00 Bcf		564.000

* $1 - \frac{4538}{7022} = .35$

1985

Total OCS Production - 4,001 Bcf

	Total Interstate Sales (Bcf)		1-OCS%*		Total Onshore Inter-State Sales (Bcf)
102	2,780	X	.42	=	1,167
103	945			=	945
104	3,549	X	.42	=	1,490
106(a)	358	X	.42	=	150
107	738			=	738
108	207			=	207
109	257	X	.42	=	108
					4,805

	% NGPA of Total Onshore Interstate Sales	X	50% Total Onshore Federal & Indian (less Alaska & Calif.)	=	Distribution of Onshore Federal and Indian Interstate Sales (Bcf)
102	0.243			=	124.659
103	0.197			=	101.061
104	0.310			=	159.030
106(a)	0.031			=	15.903
107	0.154			=	79.002
108	0.043			=	22.059
109	0.022			=	11.286
	1.000		513.0 Bcf		513.000

* $1 - \frac{4001}{6944} = 0.424$

1996

Total OCS Production - 1,984 Bcf (through July 1986)

	Total Interstate Sales (Bcf)		1-OCS%*		Total Onshore Inter-State Sales (Bcf)
102	1,181	X	.36	=	425
103	446			=	446
104	1,604	X	.36	=	577
106(a)	190	X	.36	=	68
107	258			=	258
108	104			=	104
109	110	X	.36	=	39
					1,917

	% NGPA of Total Onshore Interstate Sales	X	50% Total Onshore Federal & Indian (less Alaska & Calif.)	=	Distribution of Onshore Federal and Indian Interstate Sales (Bcf)
102	0.222			=	56.499
103	0.232			=	59.044
104	0.301			=	76.605
106(a)	0.036			=	9.162
107	0.134			=	34.103
108	0.054			=	13.743
109	0.021			=	5.344
	1.000		254.5 Bcf		254.500

* $1 - \frac{1984}{3085} = 0.357$

Attachment 4

United States Department of the Interior

OFFICE OF THE SOLICITOR
WASHINGTON, D.C. 20240

JAN - 9 1987

PRIVILEGED ATTORNEY-CLIENT COMMUNICATION

PRIVILEGED ATTORNEY WORK PRODUCT

MMS.ER.0553

Memorandum

To: Assistant Secretary, Land and Minerals Management

From: Associate Solicitor, Energy and Resources

Subject: Retroactive Modification of NTL-5

This is in response to your request that we review the case law construing retroactive rulemaking to advise you regarding the legality of retroactively modifying Notice to Lessees and Operators of Federal and Indian Onshore Oil and Gas Leases (NTL-5) -- Value of Natural Gas for Royalty Purposes.

For the reasons explained in detail herein, we have concluded from our review that a retroactive modification to NTL-5 (to make retroactive the changes to NTL-5 adopted in the July 25, 1986 rulemaking, 51 F.R. 26759) is not per se illegal. The treatise writers have recognized that: "Like retroactive statutes retroactive rules are valid if they are reasonable, but are invalid if their retroactivity is unreasonable in the circumstances." K. Davis, Administrative Law Treatise § 7:23 (2d ed. 1979). However, it also has been acknowledged that retroactive agency action is subject to stricter scrutiny than prospective measures. Daughters of Miriam Center for the Aged v. Mathews, 590 F.2d 1250, 1259 (3rd Cir. 1978). The factual circumstances surrounding a retroactive rulemaking will be determinative of the potential legality of that action. Consequently, the administrative record developed during any retroactive rulemaking process is especially important. Our analysis follows.

The first section consists of an enumeration of the standards which courts have considered in determining the propriety of retroactive agency action, followed by application of those standards to the NTL-5 situation. Sections II through VI provide a more thorough analysis of the applicable case law.

I. Application of Retroactivity Considerations To a Modification of NTL-5

From our review of the case law, a court likely would apply the following criteria if presented with a challenge to a retroactive modification to NTL-5:

- While retroactive rules are not favored, they are not per se illegal; rather, the court will consider whether the action was reasonable in the circumstances. However, courts will apply stricter scrutiny to retroactive rules than to prospective rules.

- Does the retroactive amendment to NTL-5 make the rule consistent with the statutory scheme, thereby curing a deficiency in the original rule? If so, does the public interest in proper implementation of the statute outweigh the burdens placed by retroactive rulemaking on affected parties, considering the other factors listed below?

- What was the extent of the affected parties' reliance on the original NTL-5? The court will consider such factors as: the length of time the original provision was in effect; whether the modification is an abrupt departure from past practice or merely fills gaps in an unsettled area of law; and whether the lessees or the states and Indians would have altered their conduct had the modifications been in effect originally.

- The court will consider the hardship on the affected parties, i.e. whether the hardship to the lessees from no retroactivity is outweighed by the hardship to states and Indians if the modifications are retroactive.

- The court likely will apply the same analysis whether NTL-5 is considered to be a legislative rule or an interpretative rule. However, rules like NTL-5 which establish new requirements and do not merely offer an interpretation of an existing statute or regulation, generally are deemed to be legislative rules.

Applying the factual circumstances surrounding NTL-5 to the aforementioned principles results in some considerations favoring retroactivity and others working against it.

With regard to the underlying statutory purpose, MMS's position in support of retroactive rulemaking would be that applying the original NTL-5 to establish value in the 1984-86 period will result in some values which are so high as to be unreasonable and not in furtherance of legitimate statutory purposes (the relevant statutes do not provide any explicit guidance for determining value -- it is a matter committed to agency rulemaking authority). By way of illustration, there are circumstances where the "market" price of gas sold interstate uniformly is

several dollars below the NGPA ceiling price for the category of gas. NTL-5 conclusively would establish the royalty value at the ceiling price. If this value is so high as to be unreasonable, then MMS would argue that it would be furthering the statutory purposes by curing this defect in the regulatory scheme. For Indian leases, because of the Secretary's trust responsibility to the Indians, the court may conclude that the statutory purposes test places on the Secretary an even greater burden to demonstrate that an NGPA ceiling price is patently unreasonable (hence not justified by the statutes or leases) rather than just a "high" value.

We believe that recent case law makes an even stronger case for not changing NTL-5 retroactively for Indian leases. The Tenth Circuit Court of Appeals in Jicarilla Apache Tribe v. Supron Energy Corp., 782 F.2d 855, (en banc 1986), adopting the dissent reported at 728 F.2d 1555, held that the Secretary had a fiduciary duty to manage the tribe's natural resources to maximize benefits. Id. at 1565.

In terms of relative burden, modifications to NTL-5 work to the benefit of oil and gas lessees through lower royalties. Courts have upheld retroactive application of a rule which benefitted the regulated class. However, the modifications to NTL-5 will have a corresponding negative impact on the amount of royalty revenues received by the public, Indian lessors and the states. The courts necessarily will focus on this burden. Moreover, unlike most cases involving retroactive rules applicable to a regulated class, the balancing inquiry will not be limited to considering the impact on public or governmental interests, but will consider whether the burden on all royalty recipients is outweighed by the furtherance of the statutory scheme as it relates to leasing and payment of royalties on both Federal and Indian lands.

Operating in favor of retroactivity is the fact that the conduct by at least one party, the lessees, would not necessarily have been different had the NTL-5 modifications been in effect. On most leases where the NTL-5 value was significantly in excess of a lessee's gross proceeds, it is MMS's experience that lessees did not pay royalty at the NTL-5 prescribed rate. Rather, they paid royalties based on their proceeds. In some cases, this action was taken with the knowledge and concurrence of MMS. Therefore, a retroactive modification to NTL-5 in most instances would not take money out of the pockets of the Indians and states, but only would decrease their revenues from future audits of past activity. On the other hand, enforcement of the original NTL-5 would require the lessees to pay considerable sums of additional money after having been advised earlier by MMS that NTL-5 would not apply uniformly. It will be incumbent on MMS to develop the administrative record to demonstrate that lessees did not pay royalties at the NTL-5 rate, that many lessees acted based upon advice from MMS, and that Indians particularly would not be burdened by having to refund previously paid royalties if the rule is changed retroactively.

Two principal considerations will operate against retroactivity. Most importantly, as noted earlier, the statutory interests which will be considered by the courts will include the Secretary's trust responsibility to the Indians. The retroactive rule would be altering an established policy which benefitted the Indians, not just filling in a gap which existed in the applicable law. Thus, the benefit to the oil and gas lessees will be balanced against the detriment to the Indians. While there indeed may be situations where the NTL-5 value is unreasonable, the court may be concerned whether it is necessary to rescind NTL-5's applicability to all leases to cure the problem. Instead, it may be appropriate to develop standards and make the NTL-5 changes retroactive only in certain defined circumstances.

MMS's statutory purpose argument also will be undermined by the fact that in the 1984-86 period MMS was aware of the valuation problems caused by NTL-5 but took no corrective action. The court will not be as sympathetic as in a situation where an unforeseen change in circumstances requires a retroactive modification.

Also to be considered is the standard of review which will be applied to the MMS action. If MMS makes the recent modifications to NTL-5 retroactive, the likely lawsuit from the Indians and states will focus almost exclusively on the procedural issue of retroactivity. The burden will be on the agency to defend the reasonableness of its action in general. If, on the other hand, MMS continues to enforce NTL-5 as originally promulgated, the dispute will be with the lessees and will be a substantive challenge to an agency valuation order. The agency will have in its favor the principle of law that courts should defer to the agency's decision, particularly where the agency is interpreting its own statutes and regulations. See Marathon Oil Co. v. U.S., 604 F. Supp. 1375 (D. Ak. 1985), aff'd, 794 F.2d 1461 (9th Cir. 1986). The burden will be on the lessee to demonstrate that the agency's valuation was unreasonable and not in accordance with law.

In summary, whether a retroactive modification of NTL-5 is legally defensible will depend in large measure on the administrative record developed to support the agency's decision. What follows is a more thorough review of the case law which forms the basis for this conclusion.

II. Background

As is explained in more detail below, in ruling on the propriety of a retroactive rulemaking, courts have considered carefully the facts surrounding the rulemaking action, particularly focusing on who the affected parties are. As noted by Professor Davis, above, "reasonableness" of the retroactive rule is an important criterion. The NTL-5 situation is somewhat unique. The retroactive modification under consideration would benefit oil and gas lessees through lower royalties. Generally, when an agency takes action which benefits the class it regulates, even

if that action is retroactive, the agency action will not be challenged because no specific person or class is aggrieved. Here, however, the Indian lessors (who receive all of the royalties from production on their leases) and the states (who receive 50 percent of the royalties from federal leases pursuant to 30 U.S.C. § 191) would be directly and adversely affected by a retroactive change to NTL-5 which reduced royalty payments. Thus, a retroactive rule which benefits a private party and generally would not be subject to challenge in this case operates directly to the detriment of parties other than the U.S. Government. This dual impact must be considered when applying the principles gleaned from prior case law.

III. Early Cases

The courts recognized early that retroactive agency action could be warranted. In Addison v. Holly Hill Fruit Products, Inc., 322 U.S. 607 (1944), the Supreme Court sanctioned retroactive agency action. The agency had adopted a definition under the Fair Labor Standards Act which the Court concluded was beyond the agency's authority as conferred by statute. After striking down the agency definition, the Court remanded the matter to the district court with an instruction to hold the case until the agency adopted a new definition which would be applicable retroactively to the earlier period to which the original rule had applied.

One of the most frequently cited cases establishing the early principles for determining when retroactive rulemaking is appropriate is SEC v. Chenery Corp., 332 U.S. 194 (1947). While this case is more important for having established the principle that the choice between proceeding by general rule or by ad hoc application is one that lies primarily in the informed discretion of the agency, the Court also ruled that just because an ad hoc decision of the Securities and Exchange Commission might have a retroactive effect does not necessarily render it invalid:

> Every case of first impression has a retroactive effect, whether the new principle is announced by a court or by an administrative agency. But such retroactivity must be balanced against the mischief of producing a result which is contrary to a statutory design or to legal and equitable principles. If that mischief is greater than the ill effect of the retroactive application of a new standard, it is not the type of retroactivity which is condemned by law.

Id. at 203. While this case dealt with an agency order rather than a rule, the above-quoted balancing principle has been applied by other courts to the rulemaking context.

As noted above, factual considerations surrounding a retroactive rule are an essential consideration. A later court striking down retroactive agency action noted that the rulings in Addison and Chenery may have been dictated by need since to permit the

industry to stand with no regulation (as opposed to applying the new rule retroactively) would have been contrary to the intent of Congress. National Labor Relations Board v. Guy F. Atkinson Co., 195 F.2d 141, 147-148 (9th Cir. 1952). (See also Niagara Mohawk Power v. FPC, 379 F.2d 153 (D.C. Cir. 1967), where the court upheld the retroactive effective date of a license (with the attendant higher fees) where the project otherwise would have been constructed without a license in violation of applicable law.)

The courts recognized early that when an agency adjudication is a case of first impression, it necessarily will have retroactive effect. Chenery, supra; NLRB v. Majestic Weaving Co., 355 F.2d 854 (2nd Cir. 1966). Stated another way, in a case where the agency is first announcing a rule as to how a person should have acted in a prior period, that ruling is retroactive in effect. This must be distinguished from situations, like with NTL-5, where an agency retroactively is altering an established rule which has been generally recognized and relied upon. In one case the court concluded:

> In this case we might well conclude that where for fifteen years the Board considered conditional negotiation consistent with the statutory design "the ill effect of the retroactive application of a new standard" so far outweighs any demonstrated need for immediate application to past conduct, SEC. v. Chenery Corp., supra, [citation omitted] as to render the action "arbitrary."

NLRB v. Majestic Weaving Co., supra at 860-861. Therefore, courts will be more reluctant of retroactive rulemaking where an agency first is establishing a principle rather than amending a previously established policy.

Another case which established frequently cited standards for determining the validity of retroactive agency action is Retail, Wholesale and Department Store Union, AFL-CIO v. NLRB, 466 F.2d 380 (D.C. Cir. 1972). At issue was the Board's retroactive application of a change in policy effectuated by it through adjudication rather than rulemaking. Recognizing that courts sometimes will uphold retroactive rules, the court considered the following standards:

> Among the considerations that enter into a resolution of the problem are (1) whether the particular case is one of first impression, (2) whether the new rule represents an abrupt departure from well established practice or merely attempts to fill a void in an unsettled area of law, (3) the extent to which the party against whom the new rule is applied relied on the former rule, (4) the degree of the burden which a retroactive order imposes on a party, and (5) the statutory interest in applying a new rule despite the reliance of a party on the old standard.

Id. at 390. The court in this case refused to give retroactive effect to agency action.

IV. Recent Cases

In the more recent cases, courts have focused more closely on the severity of the harm to private interests caused by retroactivity, and have acknowledged "the doctrine that an administrative agency may not apply a new rule retroactively when to do so would unduly intrude upon reasonable reliance interests." Heckler v. Community Health Services of Crawford County, Inc., 467 U.S. 51, 60 at n.12 (1984). The courts' inquiries have been even more factually oriented than in the early cases. This analysis has resulted in retroactive regulations being both sustained and overturned.

The effect of the factually-oriented inquiry is evidenced by a series of cases decided by the Temporary Emergency Court of Appeals (TECA) both upholding and striking down retroactive rulemaking actions by the Department of Energy (DOE, including predecessor agencies). In Standard Oil Co. v. DOE, 596 F.2d 1029 (TECA 1979), DOE sought to apply retroactively a petroleum price control regulation which would have imposed a significant burden on crude oil refiners. The court, which considered the principles adopted in Chenery, supra, and Retail, Wholesale, supra, reasoned as follows:

> Had the MPCI last rule been in effect during the relevant period, the refiners would admittedly have followed different procedures with respect to reduction of inventories, cutting back domestic refinery output, and avoiding constant price changes.

Id. at 1043. Thus, TECA examined whether the conduct of the affected class would have been different had the new rule been in place from the beginning. The court concluded that the rule should not be given retroactive effect.

TECA came to the opposite conclusion in two other cases. In [illegible] Oil v. DOE, 680 F.2d 156 (TECA 1982), which involved a DOE ruling regarding its crude oil pricing regulations, the court again reviewed the balancing principles from the early cases including Chenery and Retail, Wholesale. It also cited Professor Davis (same quote as in the opening section of this memorandum) in concluding both that the regulation in dispute was reasonable and that it could be given retroactive effect. However, it should be noted that the court also stated that:

> "the controlling circumstances here is [sic] that Ruling 1975-15 is an interpretative ruling, not a legislative change, and simply made explicit what was implicit in the property definition from the beginning.

Id. at 176. Thus, the rule which was upheld was not a legislative rule. Rather, the court upheld it as an interpretative rule which from the beginning was consistent with the underlying substantive rule. Consequently, its effect was not really retroactive.

The third TECA case, which involved retroactive repromulgation of a crude oil pricing rule that a court previously held to be invalid, includes an extensive legal analysis of the retroactivity issue. Mobil Oil Corp. v. DOE, 678 F.2d 1083 (TECA 1982). The court recognized that "administrative agencies have the authority, under limited circumstances, to issue retroactive rules." Id. at 1089. However, the court concluded that:

> Since the DOE has not shown that there will be a significant "mischief of producing a result contrary to statutory design . . .," Standard Oil, 596 F.2d at 1063, and since the absence of the 1974 amendment or a similar amendment does not necessarily "do violence to the law . . .", we conclude that the retroactive repromulgation of the 1979 amendment is invalid.

Id.

In most of the other recent cases, the courts have rejected retroactive rulemaking. Where retroactive effect has been approved, there appears to be a mitigating circumstance which justifies such action.

In Daughters of Miriam Center for the Aged v. Mathews, 590 F.2d 1251 (3rd Cir. 1978), HEW changed its rules on depreciation recapture after the appellant chose its depreciation method based upon the prior rules. The new rule would have created a financial hardship for appellant. The court first stated that in reviewing retroactive measures, courts have applied stricter scrutiny than with prospective measures. It reasoned further that while the validity of a prospective rule will be sustained so long as it is reasonably related to the purposes of the enabling legislation (citing Mourning v. Family Publication Service, 411 U.S. 356, 369 (1973)), "courts have generally compared the public interest in the retroactive rule with the private interests that are overturned by it in deciding whether to uphold a retroactive promulgation." Daughters, supra at 1260, Quoting from Adams Nursing Home of Williamstown, Inc. v. Mathews, 548 F.2d 1077, 1081 (1st Cir. 1977).

The court further articulated another standard:

> In a retroactivity challenge such as the present one, a critical question is how the challenger's conduct, or the conduct of others in the class, would have differed if the rule in issue had applied the from start.

Daughters, supra at 1262. This is similar to the analysis applied by TECA in Standard Oil, supra. As a consequence of its analysis the court concluded that:

> This severe impact upon the Center's finances, overturning its settled expectations, outweighs the negligible public interest in applying the new provision retroactively to it.

Id. at 1263. See also Bedford County Memorial Hospital v. HHS, 769 F.2d 1017, 1024 (4th Cir. 1985) (Court overturned retroactive rule concluding that "While retroactive rulemaking designed to cure defects in regulatory schemes sometimes should be permitted, this should only occur when the public interest in retroactively curing the defect outweighs the harm to private interests resulting from invalid first instance rulemaking").

Applying similar principles, some recent decisions also have upheld retroactive rulemaking. In People of the State of California v. Simon, 504 F.2d 430 (TECA 1974), where appellant challenged the Federal Energy Office's rescission of the state and local government exemption of crude oil from federal price controls, the court upheld a rule with retroactive effect. However, the case is somewhat unique in that the rule was made retroactive only to the date of the notice of proposed rulemaking (NOPR), and the NOPR included express notice that the rule would be made retroactive to that date when adopted.

Retroactive rulemaking also was upheld in United States v. Exxon Corporation, 561 F. Supp. 416 (D.D.C. 1983), another case construing DOE crude oil pricing regulations. The court reviewed the principles enumerated by Professor Davis, quoted above, and by the court in Pennzoil Co. v. DOE, supra, and applied a balancing test. The court approved the retroactive rule because it actually relieved the burden on the affected party.

One of the most recent cases upholding retroactive application of an agency interpretation is based upon an analysis similar to that which a court would apply in reviewing a retroactive rulemaking to NTLHE. In State of Illinois by the Illinois Department of Public Aid v. Bowen, 786 F.2d 263 (7th Cir. 1986), the State of Illinois brought an action against HHS claiming about $4 million in federal reimbursement for Medicaid medical services provided by the state. The basis of the claim was that HHS originally interpreted one of its regulations as providing a limited exemption from a statutory provision which generally denied reimbursements for the services in question. However, HHS reversed its interpretation and then denied the claims. The court reviewed most of the principles regarding retroactive application which are discussed above. It applied those principles as follows in upholding the retroactive interpretation:

> In this case any reliance interest of the [State] is outweighed by the Secretary's interest in retroactively applying its current interpretation of the regulation. A critical question is how the conduct or practices of the [State] would have been different if the current interpretation of the regulation had applied from the start. See Daughters, 590 F.2d at 1242. The district court found that Illinois would have provided the services in question regardless whether it received [federal reimbursement]. Such services are traditionally the responsibility of the states . . . . Further, this is not a case in which HHS is demanding a refund from the [State] or assessing a fine.

Id. at 292-293. The court considered also that the statutory terms seemed clear, that no other state received any funds based on the original interpretation, and that it is unlikely that the state relied heavily on the original interpretation creating a loophole in the statute.

V. Other Retroactive Royalty Cases

The question of whether a Department of the Interior royalty order could be applied retroactively was considered before in the landmark case of Continental Oil Co. v. U.S., 184 F.2d. 802 (9th Cir. 1950). The principal issue in the case was whether the Secretary's royalty valuation rules were proper. With regard to retroactivity of the so-called net realization order, the court either summarily rejected retroactive application, stating that "we think the court correctly construed the provision of the lease permitting the Secretary to fix the value of gas for royalty purposes as operating prospectively only." Id. at 821. It should be noted that the Secretary's order in this case had the effect of increasing royalties.

VI. Legislative Rules v. Interpretative Rules

It was suggested in several comments from industry that MMS could retroactively modify NTL-5, or, alternatively, that the MMS could choose not to apply NTL-5 in all circumstances, because it is only an interpretative rule as opposed to a legislative (or substantive) rule. We previously considered this issue in a May 16, 1995 memorandum to the Director, MMS, and determined that NTL-5 is a substantive rule with the force of law, and the agency is bound to enforce its terms. United States v. Nixon, 418 U.S. 683 (1974). We have revisited the issue and for the following reasons we have come to the same conclusion.

The distinction between legislative rules and interpretative rules is not easy to make with courts often differing in opinion when addressing the same fact situation. See K. Davis, Administrative Law and Government, 119 (2d ed. 1975). See also R. Schwartz, Administrative Law, 153, 154 (2d ed. 1984), which states:

> A substantive rule or "legislative-type rule" is one "affecting individual rights and obligations": . . . they create law just as the statute itself does, by changing existing rights and obligations. An interpretive rule is a clarification or explanation of existing laws or regulations, rather than a substantive modification of them. Interpretive rules are statements as to what the agency thinks a statute or regulation means: they are statements issued to advise the public of the agency's construction of the law it administers.

Professor Davis also has focused on the distinction between the two types of rules:

> One very solid proposition is this: Whenever a legislative body has delegated power to an agency to make rules having force of law (whether or not the delegation is explicit) the rules the agency makes pursuant to the granted power have the same force as a statute if they are valid, and they are valid if they are constitutional, within the granted power, and issued pursuant to proper procedure; a court may no more substitute its judgment as to the content of a legislative rule than it may substitute its judgment as to the content of a statute. . . .
>
> At the opposite extreme, where no power has been delegated to the agency to make law through rules, the agency's public statements of what it will do in enforcing or in adjudicating may be deemed "interpretative rules." The solid proposition here that is fully supported by the case law is: Courts are free to substitute judgment as to the content of interpretative rules, but they often give weight or great weight to the views of the agency, sometimes even to the extent of giving force of law to the rules. . . .

Davis, supra at 119. With regard to royalties, Congress has given the Secretary broad power to make rules having the force of law. See 30 U.S.C. § 189. Likewise, the Secretary has broad authority under the various Indian mineral leasing statutes to establish regulations governing valuation. 25 U.S.C. §§ 396, 396d. The issue is whether NTL-5 is an effectuation of that authority creating enforceable obligations, or whether NTL-5 simply interprets other royalty value regulations.

An examination of how the courts have treated the distinction between legislative and interpretive rules is helpful in deciding the question as to what type of regulation NTL-5 is.

In General Motors v. Ruckelshaus, 724 F.2d 979 (D.C. Cir. 1983), the Environmental Protection Agency (EPA) issued what it characterized as an interpretative rule requiring any auto maker to submit a plan to remedy defects in an automobile regardless of

the age or mileage. The court concluded that this was an interpretative rule, stating that the difference between an interpretative and legislative rule is a product principally of the agency's authority and intent in promulgating the rule.

In Citizens to Save Spencer County v. United States Environmental Protection Agency, 600 F.2d 844 (D.C. Cir. 1979), the EPA promulgated three rules. In its brief to the court the EPA argued that each rule was interpretative. The court agreed with the agency on the first rule which amended EPA regulations to comply with one of two conflicting sections of 1977 amendments to the Clean Air Act. The second and third rules, however, sought to fill a breach in a timing issue opened by inconsistent instructions from Congress. The court concluded that the first rule was interpretative because the EPA decided merely to follow one of the conflicting statutory instructions. On the other hand, because the second and third rules sought to fill a breach in timing, the EPA had created new law, and therefore those regulations were deemed to be legislative.

See also American Trucking Association v. United States, 688 F.2d 1337 (11th Cir. 1982), rev'd on other grounds, 467 U.S. 354 (1984); Chamber of Commerce of the United States v. Occupational Safety and Health Administration, 636 F.2d 464 (D.C. Cir. 1980).

The facts surrounding NTL-5's promulgation do not completely clarify the issue as to whether NTL-5 is legislative or interpretative. The fact that NTL-5 was issued in the "Notices" section of the Federal Register, 42 FR 22410 (May 4, 1977), and that it states only that it is issued pursuant to the authority of 30 CFR 221 (the predecessor to 30 CFR Part 206), might indicate that NTL-5 is only an interpretation of the basic gas valuation rule in 30 CFR § 206.103 (although the Office of the Federal Register did write the MMS in 1982 stating that NTL's are rules and should be classified as such).

However, more factors indicate that NTL-5 is a legislative rule. NTL-5 was promulgated in proposed form for comment (40 F.R. 54267 (Nov. 21, 1975)) before it was issued in final form. These are the procedures which the Administrative Procedure Act, 5 U.S.C. § 553, prescribes for most legislative rules (though agencies of course are free to add procedural safeguards even for interpretative rules). Also, in the NOPR for NTL-5, supra, the agency stated that "Notice is hereby given that the Geological Survey proposes to revise, effective July 1, 1976, its method of determining value for royalty purposes on gas produced from, or for the benefit of, onshore Federal and Indian oil and gas leases." (emphasis added). Therefore, it would appear that the agencies intent at the time was to "revise" the existing gas valuation procedures, which would require a legislative rule since the rules to be amended were in the C.F.R. Also, NTL-5 as finally issued includes many requirements not in 30 C.F.R. Part 206 and MMS expects lessees to comply with the requirements. This too suggests that NTL-5 is a legislative rule.

The history of NTL-5's issuance, coupled with MMS's reliance on NTL-5 as the exclusive onshore and Indian gas valuation methodology (also, recall that that was the agency's announced position in the Alaska royalty dispute with Union Oil Co.), causes us to conclude that NTL-5 is a legislative rule.

It should be noted, however, that in several of the cases concerning retroactivity discussed above, the courts applied the same analysis to the propriety of retroactive changes to interpretative rules as they did to legislative rules. See State of Illinois by the Illinois Department of Public Aid v. Bowen, supra; Daughters of Miriam Center for the Aged v. Mathews, supra; U.S. v. Exxon Corp., supra at 834 ("The fundamental criterion for determining whether a statute, regulation or interpretation may be applied retroactively is one of reasonableness." (emphasis added)); Anderson, Clayton & Co. v. U.S., 562 F.2d 972, 984 ("Neither the courts nor Congress have drawn any distinction between interpretative and legislative Treasury Regulations as regards their retroactivity.") Consequently, even if NTL-5 is considered to be an interpretative rule, the same retroactivity analysis would be necessary to determine its legality.

VII. Conclusion

For the foregoing reasons, we believe that a retroactive modification of NTL-5 may be legally defensible. However, before we can provide you with a final opinion, an administrative record that supports the agency's decision must be developed along the lines discussed above.

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